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Clients&FriendsMemo

TALF for New-Issue CMBS: New York Fed Releases Terms and Conditions, FAQs and Revised TALF FAQs

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Yesterday afternoon, the Federal Reserve Board (the "Fed") announced that, beginning in late June 2009, new-issue commercial mortgage-backed securities ("CMBS") will be eligible collateral[1] 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 this program, including the criteria for TALF-eligible CMBS and underlying assets and the required terms of the TALF loans.

The initial subscription date for CMBS will be in late June; the New York Fed expects to announce the exact date shortly. Thereafter, the subscription and settlement cycle for CMBS will occur in the latter 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 eligibility criteria for CMBS used to obtain TALF financing, as well as the expected terms of TALF financing secured by CMBS. Note that the general provisions of TALF will also apply to 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")".

Qualifying CMBS

Issue Date. TALF-eligible CMBS must be issued on or after January 1, 2009.

Currency. TALF-eligible CMBS must be U.S. dollar-denominated.

No Floating Rate CMBS. TALF-eligible CMBS must bear interest at a fixed rate or a rate based on the weighted average of the underlying fixed mortgage rates.

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[1] The Fed's announcement also stated that, in addition to CMBS, securities backed by insurance premium finance loans would also be eligible collateral under TALF. However, the terms and conditions released by the New York Fed on May 1, 2009 cover only CMBS.

> ***Note**: It is not clear why the New York Fed restricted the program to fixed rate CMBS only. This restriction mirrors the requirement that underlying loans bear interest at fixed rates. In recent years floating rate commercial mortgage loans were often secured by "transitional" or "stabilizing" properties, and perhaps the requirement that loans be fixed rate reflects a bias against financing loans on such properties. However, the requirement for current underwriting based on in-place, recurring and stable cash flow would be sufficient to exclude transitional properties from the program. See "Eligible Real Estate Collateral—Current Underwriting Based on In-Place NOI and Current Appraisals" below.*

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

No "Mezzanine" AAA CMBS. TALF-eligible CMBS must not be junior to other securities with claims on the same pool of loans.

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

DTC Clearance Required. TALF-eligible CMBS must be cleared through the Depository Trust Company.

Average Life. TALF-eligible CMBS cannot have an average life exceeding ten years. The average life of CMBS will be calculated as the remainder of the original weighted average life determined by the issuer of the CMBS based on industry-standard assumptions at the time of securitization. The average life of the CMBS will be used by the New York Fed to determine the "haircut" on the TALF financing obtained with such CMBS. See "*Terms of TALF Financing*" below.

Ratings. TALF-eligible CMBS must have the highest long-term investment-grade ratings (i.e. "AAA") from the required number of TALF CMBS-eligible rating agencies. Prior to the initial CMBS subscription date, the New York Fed will publish a list of TALF CMBS-eligible rating agencies and specify the required number of ratings. The credit ratings of TALF-eligible CMBS cannot be based on a third-party guaranty. Further, TALF-eligible 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.

Cross-Over Date. If a class of TALF-eligible CMBS is one of two or more time-tranched classes of the same distribution priority, principal payments must be made on a *pro rata* basis to all such classes after the credit support is reduced to zero as a result of both actual realized losses and appraisal reduction amounts.

> ***Note**: The use of the "appraisal reduction amount" concept to shift time-tranched "AAA" classes to receiving pro rata principal allocations is a departure*

from the prior market standard for CMBS. Commonly, the shift to pro rata allocation occurs only as a result of actual losses.

<u>"Directing Certificateholder" Definition</u>. The "Directing Certificateholder" of a CMBS transaction has certain rights to direct or otherwise influence the servicing of the underlying mortgage loans. "Directing Certificateholder" status typically resides with the most subordinate class of CMBS, unless there is a "control shift," which results in servicing control passing up the capital stack to the next most subordinate class of CMBS. In TALF-eligible CMBS, the control shift must occur once the principal balance of the junior class is reduced to less than 25% of its initial principal balance as a result of both actual realized losses and appraisal reduction amounts.

Note: The use of the "appraisal reduction amount" concept to shift control with respect to the servicing of assets is a departure from the prior market standard for fixed-rate CMBS. In many fixed-rate CMBS pooling and servicing agreements, appraisal reductions are relevant only to the calculation of the amount of P&I advances required to be made by a master servicer and do not cause a "control shift".

<u>Required Loan Seller Representation</u>. At the time of securitization, 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.

Note: Most CMBS transactions require loan sellers to make some form of representation and warranty about compliance of mortgaged properties with zoning or other laws. While the New York Fed has highlighted this representation and warranty, we anticipate that rating agencies will require loan sellers to make a full complement of standard CMBS representations and warranties.

<u>Required Appraisals</u>. The pooling and servicing agreement for TALF-eligible CMBS must also provide that property appraisals may not be recognized for any purpose under the securitization agreements unless obtained at the instruction of the mortgage loan servicer or the securitization trustee.

Note: Appraisals are typically required to be obtained with respect to mortgaged properties securing defaulted mortgage loans. Those appraisals form the basis for "appraisal reductions" and are also referred to for certain other purposes. The New York Fed's focus on the identity of the party that orders the appraisal appears to evidence a view that the party ordering the appraisal may have influence over the resulting appraised value. The release uses the term "servicer" here, without distinguishing between the master servicer and the special servicer. This may indicate that an appraisal may be ordered by either the master servicer or the special servicer.

Diversified Pools; Single-Asset CMBS Only on a Case-by-Case Basis. Generally, TALF-eligible CMBS must be backed by collateral pools that are diversified in terms of loan size, geography, property type, borrower sponsorship and other typical criteria. However, the New York Fed is willing to consider non-diversified collateral, such as the collateral in a single-asset or single-borrower CMBS, on a case-by-case basis.

> *Note: Many CMBS market participants have predicted that single-asset CMBS transactions will be the first new-issue CMBS when the market resumes, because of relative ease of execution and a reluctance on the part of lenders to undertake the "warehouse risk" inherent in originating a pool of mortgage loans over time for securitization. The New York Fed has agreed to consider such transactions as eligible for TALF, but only on a case-by-case basis.*

Periodic Reporting. The securitization documents and underlying loan agreements with respect to TALF-eligible 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.*

Qualifying Mortgage Loans

Eligible Mortgage Loans

Origination Date. The underlying mortgage loans backing TALF-eligible CMBS must be originated on or after July 1, 2008.

No Delinquent Loans. At the time of securitization, eligible mortgage loans must be current in payments of principal and interest.

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

No Future Funding Loans. At the time of securitization, eligible mortgage loans must be fully-funded.

No Second Lien Loans. The underlying mortgage loans backing TALF-eligible CMBS must be first-priority mortgage loans.

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

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

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.

Only Amortizing Loans Permitted. An eligible mortgage loan cannot provide for interest-only payments during any part of its remaining term.

Eligible Commercial Real Estate Collateral

Only U.S. Properties. The security for each mortgage loan underlying TALF-eligible CMBS must be fee or leasehold interests in one or more income-generating commercial properties located in the U.S. or a U.S. territory.

Current Underwriting Based on In-Place NOI and Current Appraisals. At the time of securitization, eligible mortgage loans must have been recently underwritten on the basis of then-current in-place, stabilized and recurring net operating income and property appraisals.

Terms of TALF Financing

Terms and Interest Rate. Each CMBS TALF loan will have either a three-year maturity or five-year maturity 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 size of each TALF loan in relation to its CMBS collateral will be determined based on the average life of the CMBS collateral. For CMBS with an average life of five years or less, the collateral “haircut” with respect to the corresponding TALF loan will be 15%. For CMBS with an average life of five to ten years, the collateral “haircut” will increase by 1% for each year of average life beyond five years. TALF-eligible CMBS cannot have an average life exceeding ten years. The average life of CMBS will be calculated as the remainder of the original weighted average life determined by the issuer of the CMBS based on industry-standard assumptions at the time of securitization.

<u>Allocation of CMBS Principal Amortization; Use of CMBS Principal to "Turbo" TALF Principal</u>. A *pro rata* portion of any principal payments received by the TALF borrower on the CMBS collateral will be allocated to reduce the principal amount of the TALF loan (in proportion to the advance rate of the TALF loan). In addition, for any five-year TALF loan, there is a "turbo" or "hyper-amortization" feature: 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 "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.

> *Note: Although the Fed responded to market participants who argued that five-year TALF financing was necessary to make TALF viable for CMBS, the Fed was concerned about the effect of extending five year loans under TALF on its ability to effectuate monetary policy by tightening the money supply. The imposition of less favorable terms for five-year TALF loans evidences a compromise between market participants' call for longer term financing and the Fed's reluctance to commit to such longer terms. Since time-tranched CMBS structures are permitted, it seems logical that tranches with shorter average lives can be structured to take advantage of the more favorable three-year TALF financing (with less refinancing risk), achieving more favorable pricing. Investors may prefer to pledge later sequential tranches under the five-year TALF financing, but may demand higher yields to compensate for the cap on current interest distributions imposed under TALF.*

<u>Collateral Monitor</u>. The New York Fed will engage a collateral monitor to evaluate CMBS that is proposed as TALF collateral. Notwithstanding any reservation of prospective TALF loans in connection with origination of new commercial mortgage loans (described below under "*Reservation of TALF Funding*"), the New York Fed will have the right to exclude specific loans from CMBS pools. In addition, the New York Fed will have the right to reject any CMBS as TALF loan collateral based on its assessment of risk.

> *Note: It is unclear to what extent the New York Fed will "pre-clear" loans to back TALF-eligible CMBS. An effective procedure for pre-clearing loans and/or more detailed guidance on acceptable underwriting standards for newly-originated loans would be helpful in giving market participants the confidence to engage in new lending.*

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

Note: AAA-rated CMBS does not typically 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.

TALF Certification Procedures. The New York Fed is currently developing a framework for issuer/sponsor certification and auditor certification with respect to TALF-eligible CMBS and it expects that the process will be announced shortly.

Reservation of TALF Funding. The New York Fed is currently considering a process to permit interested issuers to reserve prospective funding of TALF loans with respect to CMBS that are not yet issued, whereby each potential issuer who secures such a reservation would pay a monthly reservation fee based on a fraction of the amount reserved for every month that the reservation is outstanding until the CMBS are issued. Prior to the issuance of any eligible CMBS, the New York Fed would retain the right to exclude specific loans from the collateral pool. If implemented, the New York Fed expects to announce the details of this process shortly.

Note: This proposed feature appears to be designed to address the "warehouse risk" that market participants have cited as an impediment to new lending activity. However, the ability of the New York Fed to kick out loans from CMBS pools will limit the effectiveness of this device unless procedures are available to "pre-clear" loans prior to funding and/or detailed guidance is issued as to parameters for acceptable loan underwriting.

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

TALF (CMBS) Terms and Conditions, May 1, 2009

Frequently Asked Questions (CMBS), May 1, 2009

Updated Frequently Asked Questions (TALF), May 1, 2009

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

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