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The Federal Reserve Bank of New York Expands TALF to Include New Issuances of CMBS

Introduction

The Federal Reserve Bank of New York (the "New York Fed") expanded the Term Asset-Backed Securities Loan Facility (the "TALF") on May 1, 2009 to include qualifying commercial mortgage-backed securities ("CMBS") issued on or after January 1, 2009. Previously, eligible borrowers could obtain TALF non-recourse financing to purchase certain types of AAA-rated asset-backed securities ("ABS"), but CMBS were not eligible for TALF financing.[1] The first TALF subscription date for CMBS will occur in late June, 2009. While the full details of TALF for CMBS have yet to be finalized, the New York Fed has released the following details.

Qualifying CMBS

To be eligible for TALF, the CMBS must meet the following criteria:

- **Issue Date:** The CMBS must be issued on or after January 1, 2009. This means that TALF financing is not currently available for legacy CMBS.
- **Issuer:** The CMBS issuer must not be an agency or instrumentality of the United States or a government-sponsored enterprise. This means that CMBS issuances by Fannie, Freddie, or any of the other GSEs are not eligible for TALF.
- **Ratings:** There are six new ratings requirements for TALF-eligible CMBS:
  - first, the New York Fed will select a list of rating agencies that may rate CMBS for the TALF (the "CMBS TALF Rating Agencies");
  - second, the New York Fed will determine the number of CMBS TALF Rating Agencies which must rate each deal;
  - third, as of the TALF closing date, the CMBS must have a credit rating in the highest long-term investment-grade rating category from the required number of CMBS TALF Rating Agencies rating the issuance;
  - fourth, as of the TALF closing date, the CMBS must not have a credit rating below the highest investment-grade rating category from any of the other CMBS TALF Rating Agencies;
  - fifth, the CMBS must not have been placed on a watch list for review or downgrade by any CMBS TALF Rating Agency; and
  - sixth, the credit rating of the CMBS must not be based on the benefit of a third-party guarantee.

[1] For a full description of the TALF for qualifying ABS, *see* the April 2009 *DechertOnPoint* "Term Asset-Backed Securities Loan Facility (TALF)" located at www.dechert.com/library/FS_Finance_and_Real_Estate_3-09_TALF.pdf.

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- **CMBS Payment Terms:**
  - The CMBS must pay principal and interest (i.e., it cannot be an interest-only or principal-only class).
  - The CMBS must bear interest at a pass-through rate that is fixed or based on the weighted average coupon of the underlying mortgage loans (which must bear interest at a fixed rate).
  - The CMBS must not be junior to the other securities with claims in the same pool of mortgage loans. This means that subordinate AAA classes, such as "A-M" and "A-J" classes, will not be eligible. Time-tranched senior classes (i.e., senior classes that have different priorities as to distributions of principal) will be eligible if principal distributions switch to *pro rata* as described below.
  - The average life of the CMBS cannot exceed ten years.
  - The CMBS must be U.S. dollar denominated, must not be synthetic, and must not be backed by other CMBS or other securities.
  - The CMBS cannot be backed by interest rate swap or cap instruments, or other hedging instruments.
- **Settlement:** The CMBS must be cleared through the Depository Trust Company.
- **Pooling and Servicing Agreement Requirements:** Each pooling and servicing agreement governing the CMBS must include the following terms:
  - **Multiple AAA Time-Tranched Classes:** If a CMBS class is one of a number of time-tranched classes with the same interest distribution priority but with different principal distribution priorities, distributions 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." Most CMBS issuances prior to 2009 provide for switching to *pro rata* distributions of principal only on the basis of realized losses, and not based on appraisal reduction amounts.
  - **Controlling Class:** The controlling class certificateholders, who are initially the most-subordinate certificateholders, typically have some control over servicing decisions and typically lose control once they have lost 75% of their principal as a result of actual realized losses (and not as a result of imputed reductions of principal as a result of allocations of appraisal reduction amounts). The TALF requires that all TALF-eligible CMBS include imputed reductions of principal as a result of allocations of appraisal reduction amounts for the purpose of determining loss of control: "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." This requirement that subordinate certificateholders lose control as a result of actual realized losses and appraisal reduction amounts is similar to the test that would typically apply to determine whether holders of junior notes, junior participations, and rake bonds lose control.
  - **Post-Securitization Property Appraisals:** Post-securitization property appraisals may not be recognized for any purpose if the appraisal was obtained at the demand or request of any person other than the servicer for the related mortgage loan or the trustee in the related securitization.
  - **Mortgage Loan Seller Representations:** The mortgage loan seller representations must include a representation that, upon the origination of each mortgage loan, the improvements at each related property were in material compliance with applicable law. Generally speaking, this is not a new requirement for issuances of CMBS.
  - **CMBS Financial Reporting:** There must be sufficient reporting requirements to enable the New York Fed to monitor and evaluate its position as secured lender for TALF-eligible CMBS.

Qualifying Mortgage Loans

In order for CMBS to qualify for TALF financing, the underlying mortgage loans must also meet certain criteria:

- **Origination Date:** All of the mortgage loans must have been originated on or after July 1, 2008.
- **General Parameters:** The mortgage loans must be fully funded, first-priority commercial mortgage

loans that are current in payment at the time of the securitization.

- **Fixed Rate:** The mortgage loans must have a fixed interest rate (i.e., no floating-rate mortgage loans).

- **Amortization:** No mortgage loan may provide for any interest-only payments during any part of the remaining term.

- **U.S. Collateral:** The mortgage loans must be secured by one or more income-generating commercial properties located in the United States or one of its territories.

- **Fee or Leasehold**: The underlying properties may be fee or leasehold interests.

- **Participation Interests / B-Notes:** A participation or other ownership interest in a loan will be considered a mortgage loan if, following a loan default, the ownership interest is senior or *pari passu* with all other interests in the same loan in right of payment of principal and interest. This means that loans can be split into *pari passu* notes or participations and senior/junior notes or participations, but junior notes or junior participations cannot be included in the CMBS pool.

- **Loan Document Financial Reporting:** There must be sufficient reporting requirements to enable the New York Fed to monitor and evaluate its position as secured lender. This means that some changes to loan documents may be required.

- **In-Place Underwriting:** The mortgage loans must have been "underwritten or re-underwritten recently prior to the issuance of the CMBS, generally on the basis of then-current in-place stabilized and recurring net operating income and then-current property appraisals."

The TALF Loan Terms for CMBS

Loans made by the New York Fed for CMBS under the TALF must meet the following criteria:

- **Eligible Borrower:** Any U.S. company that is a business entity or institution organized under the laws of the U.S. or a political subdivision or territory thereof (U.S.-organized) and conducts significant operations or activities in the U.S., including any U.S.-organized subsidiary of such an entity, a U.S. branch or agency of a foreign bank (other than a foreign central bank) that maintains reserves with the Federal Reserve Bank, a U.S.-insured depository institution, or an investment fund that is U.S.-organized and managed by an investment manager that has its principal place of business in the U.S. Note that this is the same definition of Eligible Borrower that is set forth in the previously announced TALF for ABS.

- **Lender:** Federal Reserve Bank of New York.

- **Initial Subscription Date:** The first TALF subscription date for CMBS will occur in late June. The New York Fed will announce the specific date shortly. Subscriptions for CMBS and ABS TALF loans will take place in separately scheduled operations, with the subscription and settlement cycle for CMBS occurring in the latter part of each month.

- **Term:** Eligible Borrowers may elect a three- or five-year term. The Federal Reserve Board indicated in a press release dated May 1, 2009 that up to $100 billion of TALF loans could have five-year maturities, and that it will continue to evaluate this limit. The entire $100 billion, however, will not be available exclusively for CMBS as five-year TALF loans will also be available for specified, qualifying ABS backed by student loans and loans guaranteed by the Small Business Administration.

- **TALF Loan Interest Rate:** A three-year TALF loan for CMBS will bear interest at a fixed per annum rate equal to 100 basis points over the three-year LIBOR swap rate. A five-year TALF loan for CMBS is expected to bear interest at a fixed per annum rate equal to 100 basis points over the five-year LIBOR swap rate.

- **Collateral Haircut:** The collateral haircut for CMBS with an average life of five years or less will be 15%. For CMBS with an average life beyond five years, collateral haircuts will increase by one percentage point for each additional year of average life beyond five years. The average life of the CMBS is calculated using the remainder of the original weighted average life determined by the related issuer employing industry-standard assumptions. No TALF-eligible CMBS may have an average life beyond ten years.

- **Diversification:** The New York Fed expects collateral pools to be diversified with respect to loan size, geography, property type, borrower sponsorship, and other characteristics. The New York Fed, however, may consider exceptions on a case-by-case basis.

- **Collateral Monitor / Loan Exclusions:** The New York Fed will engage a collateral monitor and will reserve the right to exclude specific loans from pools prior to a TALF-eligible securitization.

- **Exclusion of CMBS:** The New York Fed reserves the right to reject any CMBS as TALF loan collateral based on its risk assessment.

- **Principal Payments:** Any payment 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 (i.e., if the advance rate is 85%, 85% of each principal payment must be remitted to the New York Fed to pay down the outstanding principal balance of the TALF loan). This is the same principal payment methodology used for TALF loans for ABS.

- **Hyper-Amortization for Five-Year TALF Loans:** For the first three years of five-year TALF loans, the excess of CMBS interest distributions over the underlying TALF loan interest payable will be remitted to the TALF borrower only until such excess equals 25% of the haircut amount, and the remainder will be applied to the TALF loan principal. During the fourth year of the TALF loan, such percentage will be equal to 10%, and during the fifth year of the TALF loan, such percentage will be equal to 5%. No such hyper-amortization requirement exists for a three-year TALF loan.

- **Voting, Consent, and Waiver Rights:** The TALF borrower must agree not to exercise or refrain from exercising any voting, consent, or waiver rights it has with respect to CMBS without the consent of the New York Fed.

- **Issuer, Sponsor, and Auditor Certification:** A framework for certifications is being developed and will be available shortly.

- **Reservation of TALF Funding:** The New York Fed is considering a process to permit CMBS issuers to reserve prospective funding of TALF loans collateralized by new issuances of CMBS. This program would likely require the issuer to pay a monthly reservation fee calculated as a fraction of the amount reserved for each month the reservation is outstanding. No reservation will extend beyond the last CMBS subscription date. Further details related to this process will be announced shortly. This should assist issuers in obtaining warehouse financing or other capital so they can accumulate a sufficiently sized pool to securitize.

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A Comparison of Pre-TALF CMBS and TALF CMBS

Requirement	Pre-TALF CMBS	Newly Issued TALF-Eligible CMBS
CMBS Issuance Date	Any time	On or after January 1, 2009
Interest Rate	Fixed or Floating	Fixed
Issuer	Any	A U.S. agency or instrumentality or a GSE, such as Fannie or Freddie, is not eligible
Rating Agencies	Any Nationally Recognized Statistical Rating Organization; typically S&P, Moody's and/or Fitch	Must be approved by New York Fed Must be a specific number of agencies rating each deal As of the TALF 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 approved rating agencies rating the issuance, and the CMBS must not have a credit rating below the highest long-term investment-grade rating category from any other TALF CMBS approved rating agency
Settlement	No requirement	Depository Trust Company only
Time-Tranched Senior AAA Classes	Eligible	Eligible only if principal distributions switch to *pro rata* distributions once the credit support is reduced to zero based on both realized losses and imputed losses through appraisal reduction amounts

Requirement	Pre-TALF CMBS	Newly Issued TALF-Eligible CMBS
Post-Securitization Property Appraisals	Could be obtained at request of parties other than servicer or trustee (e.g., B Note holders or subordinate certificateholders)	Post-securitization property appraisals may not be recognized for any purpose if the appraisal was obtained at the demand or request of any person other than the servicer for the related mortgage loan or the trustee
Loss of Control Based on Appraisal Reduction Amounts	For pooled classes, loss of control is generally based on actual realized losses exceeding 75% of initial principal amount of such classes; allocation of appraisal reduction amounts not usually considered	Loss of control must be based on both actual realized losses and appraisal reduction amounts; if actual realized losses and appraisal reduction amounts allocated to a class exceed 75% of the initial principal amount of such class, control shifts
Representations and Warranties	Market driven; typically included a long list	Market driven; expected to include long list, but must represent that the improvements at the mortgaged properties are in compliance with the law
Financial Reporting	Market driven	Market driven and must also satisfy New York Fed
Loan Funding	Some loans had future funding obligations	Loans must be fully funded
Loan Splitting	Permitted; junior notes and junior participations occasionally included in CMBS trust	Permitted, however, junior notes and junior participations are not permitted to be included in the CMBS trust
Loan Origination Date	Any time	On or after July 1, 2008
Amortization	Interest only or amortizing	Amortizing only
Location of Real Estate	No limitation	U.S. or U.S. territories only

Requirement	Pre-TALF CMBS	Newly Issued TALF-Eligible CMBS
Underwriting Method	No specific requirement; *pro forma* underwriting was not uncommon in recent years	Recently underwritten generally on basis of then-current in-place, stabilized and recurring net operating income and then-current property appraisals
Loan Level Financial Reporting	Market driven	Market driven and must be acceptable to New York Fed
Right to Kick Out Mortgage Loans from Pool	Typically available to B-piece buyer	Available to B-piece buyer and New York Fed