

**Ups and Downs for Legacy CMBS: TALF Expands, but S&P Signals Downgrades**

Peter K. McKee, Jr., Charles T. Marshall, Patrick C. Sargent & Peter Bogdanow

May 29, 2009

Recent developments presage dramatic impacts for CMBS market participants. First, the good news: with its May 19 announcement that the Term Asset-Backed Securities Lending Facility (TALF) would be expanded to include pre-2009 commercial mortgage-backed securities (Legacy CMBS), the Federal Reserve has given investors some intriguing options among government programs intended to revive securitization. Then came the not-so-good: Standard & Poor’s (S&P) announced on May 26 that it is reviewing its credit rating methodologies. S&P projected the review would result in significant downgrades on the most senior AAA class securities (the so-called “dupers”) for the 2005-2007 vintages of Legacy CMBS. Such a consequence would dramatically curtail the Legacy CMBS that would be TALF-eligible collateral under current rules.

We consider each of these developments below.

**TALF EXPANDS TO LEGACY CMBS: THE TALF AND PPIF ALTERNATIVES**

Following on the heels of its May 1 action to include “new issue” CMBS as TALF-eligible collateral, the Federal Reserve’s inclusion of Legacy CMBS was still welcomed, if not unexpected, by the market. AAA spreads immediately tightened on the news. The effect was to give investors more choices in how to purchase Legacy CMBS, either through (i) TALF (Legacy TALF); (ii) the Legacy Securities Program (Legacy Securities PPIF), which is a component of the Public-Private Investment Program; or (iii) a combination of both, where the fund manager for a Public-Private Investment Fund (PPIF) elects to use TALF financing. Combining the TALF and PPIF alternatives entails satisfying both sets of eligibility criteria and requirements. The chart examines some key points of comparison between the two programs, and examples of the TALF, PPIF, and “combination” financing alternatives follow. (For ease of reference, a TALF borrower is called an “investor” in the chart where contextually appropriate.)

<b>Feature</b>	<b>Legacy TALF</b>	<b>Legacy Securities PPIF</b>
Collateral Requirements	<u>Credit Rating:</u> CMBS must <i>currently</i> be rated AAA by at least two of S&P, Moody’s, Fitch, DBRS and Realpoint, and no rating from any of those agencies below AAA.	CMBS must have been <i>originally</i> rated AAA by at least two of S&P, Moody’s, Fitch, DBRS and Realpoint.
	<u>Seniority:</u> Only most senior (“duper”) AAA classes (A-1, A-2, etc., but not AM or AJ classes) are eligible.	No corresponding limitation on AAA class (AM and AJ classes eligible).
	<u>Location:</u> At least 95% of the credit exposures underlying the Legacy CMBS, by dollar amount of principal loan balance, must be exposures on properties located in the U.S. or one of its territories.	The loans underlying Eligible Assets must be situated predominantly in the U.S., subject to further clarification by Treasury.

continues...

Collateral Requirements (continued)	<u>Rate/Payment Terms</u> : Fixed rate CMBS only; also, principal amortizing bonds only.	No corresponding limitation (fixed rate or floating rate CMBS eligible; interest-only bond classes eligible).
Seller Requirements	At least 95% of the credit exposures underlying the Legacy CMBS, by dollar amount of principal loan balance, must be exposures that are originated by U.S. organizations or entities or U.S. branches of foreign banks.	Eligible Assets may only be purchased from U.S. "financial institutions," which include banks, savings associations, security brokers or dealers, or insurance companies established and regulated, and having significant operations in the U.S, (but excluding foreign government-owned banks or institutions).
Government Equity	None	Treasury matches private equity dollar-for-dollar.
Government Debt	Non-recourse financing available for the investor's purchase price less a "haircut" equal to at least 15% of the face value for CMBS having an average weighted life of 5 years or less. Haircut increases 1% with each additional year of average weighted life above 5 years (see Scenarios #1 and #2 below).	Non-recourse financing available up to 50% of PPIF's total equity capital, with possibility of financing up to 100% of PPIF's total equity capital, subject to additional restrictions on asset level leverage, withdrawal rights, cash flow priority or disposition priority (see Scenarios #1 and #2 below).
Debt Terms	For 5 year loan, interest rate is 5 year LIBOR swap rate + 100 bp. For 3 year loan, interest rate is 3 year LIBOR swap rate + 100 bp.	Debt terms not generally available at this time. Interest rates on loans made by Treasury to any PPIF will be determined by Treasury. PPIFs may finance purchase of CMBS through Legacy TALF, any other treasury program or third-party debt financing <i>provided</i> Treasury equity and private equity are leveraged proportionately from such private debt financing sources.
Warrants	No	Yes. Treasury will receive warrants in the PPIF.

continues...

Investor Access/ Requirements	Any "U.S. Company" (includes U.S.-organized business entities with significant domestic operations) that has an account relationship with a primary dealer may borrow under TALF.	Investors buy shares in a PPIF from a "fund manager." Initially 5 fund managers will be pre-qualified, based on near-term capital raising ability (\$500 million) and legacy securities under management (\$10 billion). Treasury's announcement of initial fund managers is now expected in early June.
Affiliate Restrictions	CMBS may not be backed by loans originated or securitized by investor or its affiliate.	A Fund Manager may not, directly or indirectly, acquire CMBS from or sell CMBS to its affiliates, any other PPIF or any private investor that has committed 10% or more of the aggregate capital raised by the PPIF.
Reporting	Subject to oversight of New York Federal Reserve, which will require "reasonable" reports on the loan and collateral.	Subject to oversight of Treasury. Fund Managers will be required to present monthly reports to Treasury on CMBS purchases and sales, current valuations and profits/losses. Prices of CMBS for reporting purposes must be tracked using third-party sources and annual audited valuations by a nationally recognized accounting firm.
Management Fees	No restrictions	Fund Managers may charge management fees, but not carried interest fees, to Treasury, and propose in their applications to the Treasury the right to charge such fees to private investors.
Withdrawal Rights	No restrictions on withdrawals and no requirements for forced withdrawals.	No private investor may withdraw from the PPIF within 3 years of the PPIF's first investment. If a PPIF receives Treasury debt financing, private investor withdrawals are prohibited.  Treasury may withdraw at any time from the PPIF.

continues...

Funding Caveats	For Legacy CMBS, TALF funding is expected if an eligible borrower posts eligible collateral (absent materially adverse information about the borrower prior to settlement).	Treasury has the right to deny funding to any PPIF for debt or equity financing for any reason.
Executive Compensation Restrictions	No restrictions	No restrictions apply to asset managers or private investors so long as PPIFs are structured so that (i) asset managers and their employees are not employees of or controlling investors in the PPIFs, and (ii) other investors are purely passive.
Employ American Workers Act	Investors must comply with the Employ American Workers Act (which prevents displacement of U.S. workers when hiring H1-B specialty occupation workers).	Not applicable

For investors the two programs represent distinctive choices. Legacy TALF is better suited for the investor interested in actively managing its Legacy CMBS investment, while PPIP is aimed at the passive investor content to rely upon the PPIF fund manager’s investment composition. Legacy TALF avoids the PPIP warrants, but its “duper-only” and “fixed rate-only” collateral criteria are more restrictive than PPIP’s. TALF includes no restrictions on withdrawals, while PPIP locks out private investors for 3 years, and prohibits private investor withdrawals altogether if the PPIF receives Treasury financing. TALF’s “LIBOR + 100 bp” financing terms are specified and favorable, but investors have to factor in the TALF “haircut” compared to the leverage ratios that will be required under PPIP.

Treasury’s debt terms for PPIP have yet to be announced. Subject to certain affiliate restrictions, TALF can also be used for either purchase money acquisitions or refinancing of Legacy CMBS.

The scenarios below also demonstrate essential program differences, and, in particular, the private equity requirements and government proceeds (both equity and debt) available.

**Scenario #1**

An investor wishes to purchase a CMBS with a face value of \$100 and a market value of \$75. Also, (i) Treasury will match equity financing (including the Treasury portion) with debt financing; and (ii) the averaged-weighted life of the CMBS is 7 years, so that the haircut is 17% (2% over the 15% base haircut for 2 additional years above 5 year average-weighted life).

<b>PPIP</b>	<b>TALF</b>	<b>Combination</b>
Investor will receive \$37.50 in Treasury Debt to match \$37.50 in total equity.	Investor will receive a TALF Loan equal to \$58, resulting from a haircut of \$17.	PPIP will receive a TALF Loan equal to \$58, resulting from a haircut of \$17.
Investor will only need to raise \$18.75 in private capital.	Investor will only need to raise \$17 in private capital (the amount of the haircut).	Investor will only need to raise \$8.50 in private capital (Treasury matches private capital with additional \$8.50).

**Scenario #2**

An investor wishes to purchase a CMBS with a face value of \$100 and a market value of \$50. Also, (i) Treasury will match equity financing (including the Treasury portion) with debt financing; and (ii) the averaged-weighted life of the CMBS is 6 years, so that the haircut is 16% (1% over the 15% base haircut for the additional year above 5 year average-weighted life).

<b>PPIP</b>	<b>TALF</b>	<b>Combination</b>
Investor will receive \$25 in Treasury Debt to match \$25 in total equity.	Investor will receive a TALF Loan equal to \$34, resulting from a haircut of \$16.	PPIP will receive a TALF Loan equal to \$34, resulting from a haircut of \$16.
Investor will only need to raise \$12.50 in private capital.	Investor will only need to raise \$16 in private capital (the amount of the haircut).	Investor will only need to raise \$8 in private capital (Treasury matches private capital with additional \$8).

Additional information regarding the TALF program, including term sheets and FAQs, may be found at <http://www.newyorkfed.org/markets/talf.html>. Additional information on Legacy Securities PPIP can be found at <http://www.treas.gov/initiatives/eesa/>.

**S&P REVIEWS CREDIT RATINGS METHODOLOGY; PROJECTS DOWNGRADES**

S&P released a Request for Comment (Report) on proposed changes to its CMBS rating methodology on May 26 that reverberated throughout the market. The Report’s punch line: the proposed changes could result in significant downgrades to even the most senior AAA bonds or “dupers” from the 2005-2007 vintages of Legacy CMBS. If accurate, those bonds would no longer be eligible for Legacy TALF. S&P notes that approximately 25%, 60%, and 90% of the most senior tranches (by count) within the 2005, 2006, and 2007 vintages, respectively, may be downgraded. Analysts were taken aback that a commercial real estate model could show such severe risks to such well-insulated bond classes,

particularly after S&P had indicated about one month ago that there were not expected to be losses or downgrades among such classes.

Sorting out the net effect of all this is a speculative endeavor at this point. S&P is accepting comments on its revised model until June 2, so there is at least some possibility of ameliorative corrections. Failing that, given S&P's extensive market presence in rating Legacy CMBS deals, some responsive changes by the New York Federal Reserve to TALF's eligibility criteria may be necessary to prevent S&P's actions from eviscerating the TALF program altogether.

#### **ANDREWS KURTH'S ECONOMIC RECOVERY/GOVERNMENT OPPORTUNITIES TASK FORCE**

In response to the current economic downturn and the evolving governmental approach to abate its effects, Andrews Kurth formed its Economic Recovery/Government Opportunities Task Force (ERGO). ERGO is a cross-disciplinary effort designed to assist our clients in three broad areas related to economic recovery: (i) the Financial Stability Plan, including Government initiatives such as TALF and PPIP that are intended to re-establish viable markets and create opportunities for the business and investment community; (ii) Recovery Act/Stimulus Appropriations, including the 2009 American Recovery and Reinvestment Act; and (iii) Financial Regulatory matters, including prospective changes to the regulatory framework of financial institutions and financial intermediaries, and the reallocation of enforcement authority among federal and/or state authorities.

Andrews Kurth remains committed to keeping the business community informed about these developments and potential opportunities.

#### **FOR MORE INFORMATION PLEASE CONTACT:**

**Patrick C. Sargent**

1717 Main Street, Suite 3700  
Dallas, TX 75201  
214.659.4430 or  
psargent@andrewskurth.com

**Peter K. McKee, Jr.**

1717 Main Street, Suite 3700  
Dallas, TX 75201  
214.659.4507 or  
pmckee@andrewskurth.com

**Charles T. Marshall**

1717 Main Street, Suite 3700  
Dallas, TX 75201  
214.659.4509 or  
cmarshall@andrewskurth.com