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More News Regarding CMBS as Eligible Collateral for TALF Loans

On May 19, 2009, the Federal Reserve Bank of New York (the "New York Fed") announced that eligible collateral for loans under its Term Asset-Backed Securities Loan Facility ("TALF")[1] will be expanded to include U.S. dollar-denominated, cash (*i.e.*, not synthetic) commercial mortgage-backed pass-through securities ("CMBS") issued before January 1, 2009 ("legacy CMBS") as to which all required conditions relating to underlying assets, current ratings, original seniority, payment terms, type of issuer and form of settlement have been satisfied.[2] Also on May 19, 2009, the New York Fed provided various clarifications regarding the use of CMBS issued on and after January 1, 2009 ("new issue CMBS") as collateral for a TALF loan. The initial subscription date for new issue CMBS will be June 16, 2009, and the initial subscription date for legacy CMBS will be in late July 2009.[3]

Underlying Assets

General. In order to qualify as eligible collateral for a TALF loan, a CMBS — regardless of whether it is new issue CMBS or legacy CMBS — must evidence an interest in a trust fund consisting of mortgage loans satisfying the applicable criteria described under "—Qualifying Mortgage Loans" below, and not other CMBS, other securities or interest rate swap or cap instruments or other hedging instruments.

Qualifying Mortgage Loans. Each mortgage loan underlying a legacy CMBS pledged as collateral for a TALF loan:

- must be fully-funded; and
- must be secured — or, if payments due under the loan have been defeased, must have been previously secured — by a mortgage or similar instrument that creates a lien on a fee or leasehold interest in one or more income-producing commercial properties.

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1 Pursuant to TALF, which commenced operations on March 17, 2009, the New York Fed has provided non-recourse loans to investors in various types of asset-backed securities ("ABS"), provided that such investors qualify as "eligible borrowers."

2 Details relating to TALF-eligible legacy CMBS are set forth in the following publications available on the New York Fed's TALF website: (i) the Term Asset-Backed Securities Loan Facility (Legacy CMBS): Terms and Conditions (the "TALF (Legacy CMBS) Terms and Conditions") located at *http://www.newyorkfed.org/markets/talf_cmbs_terms.html*; and (ii) the Term Asset-Backed Securities Loan Facility (Legacy CMBS): Frequently Asked Questions (the "TALF (Legacy CMBS) FAQs") located at *http://www.newyorkfed.org/markets/talf_cmbs_faq.html*. Except as otherwise described in the TALF (Legacy CMBS) Terms and Conditions and the TALF (Legacy CMBS) FAQs, the general terms and conditions of the TALF program also apply to TALF loans that are secured by legacy CMBS. For details on such general terms and conditions, reference is made to the following publications, also available on the New York Fed's TALF website: (i) the Term Asset-Backed Securities Loan Facility: Terms and Conditions (the "General TALF Terms and Conditions") located at *http://www.newyorkfed.org/markets/talf_terms.html*; and (ii) the Term Asset-Backed Securities Loan Facility: Frequently Asked Questions (the "General TALF FAQs") located at *http://www.newyorkfed.org/markets/talf_faq.html*.

3 According to the TALF (Legacy CMBS) FAQs, the subscription and settlement cycle for CMBS will occur in the latter part of each month, whereas the cycle for non-CMBS ABS TALF asset classes and premium finance ABS will remain at the beginning of the month.

In contrast, each mortgage loan underlying a new issue CMBS pledged as collateral for a TALF loan:

- must be fully-funded;
- must be current in payment at the time of securitization;
- must bear a fixed rate of interest;
- may not provide for interest-only payments during any part of its remaining term;[4]
- must be secured by a mortgage or similar instrument that creates a first-priority lien on a fee or leasehold interest in one or more income-producing commercial properties;
- must have been originated on or after July 1, 2008;[5] and
- 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.[6]

In addition, in each case as of the TALF loan subscription date:

- with respect to both legacy CMBS and new issue CMBS, at least 95% of the credit exposures underlying a TALF-eligible CMBS must be exposures originated by U.S.-organized entities or institutions or U.S. branches or agencies of foreign banks; and
- with respect to legacy CMBS, at least 95%, and with respect to new issue CMBS, 100%, of the credit exposures underlying a TALF-eligible CMBS must be secured by properties located in the United States or one of its territories.[7]

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4 However, the New York Fed has not specified any maximum amortization term.

5 This origination date requirement appears to apply to "all" of the underlying mortgage loans in a given commercial mortgage-backed securitization, rather than to "all or substantially all" (which has been deemed by the New York Fed in most instances to be 85%), as is the standard for most other TALF-eligible underlying credit exposures, such as equipment loans, auto loans, credit card receivables and servicer advances.

6 At this time the New York Fed has not prescribed specific underwriting parameters that would be applicable to commercial mortgage loans, *e.g.*, maximum loan-to-value ratios or minimum debt service coverage ratios. Further, the New York Fed has not provided any guidance as to the degree of consideration that can be afforded to various aspects of commercial properties that have historically been factored into the underwriting process, including: the treatment of reserves, master leases, operating leases and executory leases, the utilization of projected or estimated fees and expenses (including management fees, utilities, repairs and maintenance and taxes and insurance) in underwriting, and the making of certain assumptions regarding vacancies, leasing and other relevant matters.

7 With respect to other classes of TALF-eligible ABS, the General TALF Terms and Conditions provides that one of the following two alternative tests (regarding obligor domicile or property location) may be satisfied: "[a]ll or substantially all of the credit exposures underlying eligible ABS must be exposures that are ... made to U.S.-domiciled obligors or with respect to real property located in the United States or one of its territories." Because of the specific requirements imposed under TALF for CMBS regarding the location of the mortgaged properties securing the underlying credit exposures, the domiciles of the related obligors is not relevant with respect to CMBS.

Accordingly, unlike new issue CMBS, legacy CMBS may still constitute TALF-eligible collateral even though the related trust fund includes one or more mortgage loans that:

- were not current in payment at the time of securitization;[8]
- bear a floating rate of interest;[9]
- provide for interest-only payments during some or all of the remaining term;
- are secured by a mortgage or similar instrument that creates a subordinate lien on the related real property collateral;
- are secured by properties that are being repositioned or otherwise do not have a stabilized cash flow; or
- with respect to up to a maximum of 5% of the total underlying credit exposures, are secured by properties located outside the United States and its territories.

Participations and Other Ownership Interests in Mortgage Loans. Both the General TALF Terms and Conditions, with respect to new issue CMBS, and the TALF (Legacy CMBS) Terms and Conditions, with respect to legacy CMBS, provide for when a participation or other ownership interest in a mortgage loan will itself be considered a mortgage loan for purposes of inclusion in the related trust fund. In both cases, the exact wording used by the New York Fed is as follows: "A participation or other ownership interest in such a loan will be considered a mortgage loan and not a 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." The phrase "in such a loan" refers to: (i) in the case of new issue CMBS, a fully-funded, first-priority mortgage loan that is current in payment at the time of securitization; and (ii) in the case of legacy CMBS, a fully-funded mortgage loan. As stated above, a mortgage loan — and, accordingly, a mortgage participation — underlying legacy CMBS is not required to provide for any amortization prior to maturity. In contrast, based on the General TALF Terms and Conditions, it appears that a mortgage participation underlying new issue CMBS would be expected to provide for some amortization each month and a fixed rate of interest. In the case of new issue CMBS, the New York Fed has not specified how principal collections on the underlying mortgage loan may be allocated to multiple mortgage participations or other loan interests prior to a loan default (other than the requirement that there be some amortization of the trust participation). It remains a question, therefore, whether the New York Fed would permit a participation or other interest held outside the subject securitization trust to hyper-amortize relative to the trust interest prior to a default, and then become *pro rata* pay as to principal and interest post-default.

The requirement that any mortgage participation that backs TALF-eligible legacy CMBS must not be subordinate in right of payment of principal or interest following a loan default creates somewhat of an anomalous situation. Apparently, the trust fund for legacy CMBS may include a subordinate lien mortgage loan or a senior participation interest therein, but may not include a subordinate participation interest in a first lien mortgage loan.

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[8] Despite this greater flexibility, it is unlikely that AAA-rated legacy CMBS would have been backed by a material concentration of — or for that matter any — mortgage loans that were 30 days or more delinquent at the time of securitization.

[9] Because the pass-through rate for a TALF-eligible legacy CMBS must be either fixed or based on the weighted average of the underlying fixed mortgage rates, it would be unlikely for the related trust fund to include a large proportion of floating rate mortgage loans.

Split Loan Structures. The New York Fed has not yet expressed its views on the inclusion of promissory notes from a split loan structure in a TALF-eligible CMBS trust. A "split loan structure" involves two or more promissory notes that are collectively secured by the same mortgage instrument encumbering the same property. The New York Fed's pronounced underlying mortgage loan criteria may not be readily applicable when a split loan structure is involved.

Only first priority mortgage loans can back TALF-eligible new issue CMBS. However, in a split loan structure, all of the related promissory notes would constitute first priority mortgage loans secured by the same first lien mortgage, but one or more such notes may be contractually senior in right of payment to one or more other such notes pursuant to a co-lender, intercreditor or other similar arrangement. By analogy to the participation structure, and in light of the economic similarity between the split loan structure and the participation structure, a promissory note from a split loan structure satisfying the criteria described under "—Qualifying Mortgage Loans" above should be acceptable for inclusion in a TALF-eligible CMBS transaction — regardless of whether legacy CMBS or new issue CMBS are involved — if, following a loan default, the subject promissory note is, with respect to right of payment of principal and interest, senior to or *pari passu* with all other promissory notes comprising the same split loan structure.

A more difficult analysis arises with respect to a subordinate promissory note from a split loan structure. The New York Fed could take one of the following three positions. If the New York Fed agrees that it evidences a separate mortgage loan and, together with the more senior promissory note(s) from such split loan structure, is secured by a first lien mortgage on the related real property collateral, then — subject to satisfaction of the other requisite criteria — it would be suitable for inclusion in a trust fund for both new issue CMBS and legacy CMBS. If the New York Fed views such subordinate promissory note as the economic equivalent of a junior lien mortgage loan, then — subject to satisfaction of the other requisite criteria — it could be included in a trust fund for legacy CMBS but not in a trust fund for new issue CMBS. If the New York Fed considers such subordinate promissory note as the economic equivalent of a subordinate participation interest, then it would not be an acceptable underlying credit exposure for either new issue CMBS or legacy CMBS.

The New York Fed has stated that only fully-funded mortgage loans can back TALF-eligible CMBS. In the case of a split loan structure, the future funding obligation could be evidenced by a promissory note outside of the subject securitization trust. Depending on the purpose of the future funding (*i.e.*, not to fund construction or major renovations) and assuming that the related real property collateral is generating stabilized cash flow, the New York Fed might not object to such an arrangement. However, the New York Fed's ultimate decision on the matter may depend on whether they characterize the respective promissory notes from a split loan structure, as discussed in the preceding paragraph, as akin to a separate mortgage loan or a participation. If the latter, then, as discussed under "—Participations and Other Ownership Interests in Mortgage Loans" above, a participation or other ownership interest in a mortgage loan that is not fully-funded would not qualify as a separate mortgage loan for purposes of backing TALF-eligible CMBS (even if the future funding obligation was linked to a participation or other ownership interest outside the relevant securitization trust). In that vein, some thought will need to be given as to if and when it will be acceptable to include a promissory note from a split loan structure (or a participation or other ownership interest in a mortgage loan where the remaining interests are held outside the securitization trust) in a TALF-eligible CMBS transaction if such split loan structure (or mortgage loan) would not have been able to have been included in its entirety, but the subject promissory note (or participation or other ownership interest) was rendered compliant by attaching the offending characteristic to another promissory note (or participation or other ownership interest) that is to be held outside the securitization trust.

New York Fed Rejection Rights; Collateral Monitor. The New York Fed may reject a legacy CMBS as collateral for a TALF loan based on factors including, but not limited to, the following:

- the CMBS does not meet the explicit requirements stated in the TALF (Legacy CMBS) Terms and Conditions;
- unacceptable performance of the underlying mortgage loan pool; and
- unacceptable concentrations.

Similarly, the New York Fed may reject a new issue CMBS, the related mortgage loan pool or specific loans in the related mortgage loan pool based on factors including, but not limited to, the following:

- the CMBS or the individual loans do not meet the explicit requirements stated in the General TALF Terms and Conditions;
- unacceptable concentrations; and
- one or more of the individual loans is defaulted, delinquent in payment or in special servicing.

In connection with the foregoing, the New York Fed has stated that:

- it will utilize the services of one or more agents in connection with the review of both legacy CMBS and new issue CMBS and the respective mortgage loan pools that back them;
- it may reject 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;"[10] and
- it may reject both legacy CMBS and new issue CMBS that "represent 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 and geographic region) considered unacceptable to the New York Fed."

According to the General TALF Terms and Conditions, the New York Fed reserves the right, until the issuance of any CMBS, to exclude specific loans from the related mortgage loan pool. This right on the part of the New York Fed would seem to duplicate the right historically afforded to the purchaser of subordinate securities in a typical CMBS transaction (the b-piece buyer). The sponsors and underwriters of a commercial mortgage-backed securitization typically enter into a bid letter agreement with the b-piece buyer whereby such entity has the right to reject collateral not complying with certain agreed upon parameters (which may be broad and largely at the discretion of the b-piece buyer) at any time prior to pricing of the subject CMBS. It remains to be seen what the b-piece buyers' obligations, with respect to purchasing the agreed upon subordinate CMBS and maintaining the agreed upon pricing, will be if the New York Fed rejects collateral that such bond buyer was relying on as being part of the collateral pool. In addition, it would be problematic if the New York Fed rejects loans from a pool during the period after pricing of the CMBS and prior to issuance. CMBS underwriters and placement agents would be in a position of potentially failing on trades with committed purchasers of the CMBS,

10 Presumably, "subordinate-priority loans" includes both contractually subordinate promissory notes from a split loan structure as well as separate mortgage loans secured by a subordinate lien on the related real estate collateral.

unless disclosure of this kick-out right of the New York Fed was deemed sufficient to forestall the risk of any material misstatements prior to pricing.

Diversity of Collateral Pool. As noted above, the New York Fed is prepared to reject both legacy CMBS and new issue CMBS for unacceptable concentrations in the underlying mortgage loan pool.

In addition, the New York Fed has stated in the General TALF Terms and Conditions that it expects collateral pools backing new issue CMBS pledged to secure a TALF loan "to be diversified with respect to loan size, geography, property type, borrower sponsorship and other characteristics, but will consider CMBS backed by non-diversified collateral on a case-by-case basis." However, it has not yet offered any guidance as to what constitutes diversity in this context. Accordingly, it remains unclear as to what specified concentrations of any of the foregoing characteristics in a given pool will render such pool not sufficiently diverse.

The New York Fed has further stated in the General TALF Terms and Conditions, with respect to new issue CMBS, that "[w]hile pools containing loans from a single borrower or limited to a single asset class are not ineligible *per se*, they will be subject to a higher level of scrutiny and to the expectation that the increased concentration of the pool will be reflected in the higher creditworthiness of the pool collateral and/or in the level of credit support. If the collateral composition or the level of credit support do not satisfy the New York Fed, the pool will be rejected."

Notwithstanding the foregoing, single-asset/single-borrower securitizations, either involving a single borrower and a single, significant property or multiple affiliated borrowers and several cross-collateralized properties, may be the easiest to engineer and carry-out for purposes of creating TALF-eligible new issue CMBS in light of (i) the current dearth of securitizable mortgage loans and (ii) the TALF requirements that the loan origination and the CMBS issuance be relatively recent. Creating eligible mortgage loans might require some re-engineering/modifications at the mortgage loan level, in addition to modifications of applicable participation, co-lender, intercreditor or similar agreements to facilitate the creation of AAA-rated CMBS that is TALF-eligible. In addition, investors and the New York Fed may find it easier to assess risk associated with and evaluate securitizations consisting of one asset or a few assets.

Exclusion of Certain Underlying Assets. Based on a literal reading of the TALF (Legacy CMBS) Terms and Conditions, in the case of legacy CMBS, and the General TALF Terms and Conditions, in the case of new issue CMBS, TALF-eligible CMBS cannot evidence an interest in a trust fund that includes other CMBS, other securities or interest rate swap or cap instruments or other hedging instruments, even if such items are intended to support solely CMBS that will not be pledged as collateral for a TALF loan. In several legacy CMBS transactions involving a pool of fixed-rate commercial mortgage loans, an interest rate swap contract has been used to issue a floating rate class of CMBS. Such an interest rate swap contract is not intended to support or relate to any other class of CMBS of the same series. If such an interest rate swap contract has been included in the same trust fund as the underlying mortgage loans, then, as a technical matter, it is arguable that no class of CMBS issued out of such trust fund could be TALF-eligible collateral. Although this seems to be an unlikely position, it may be worthwhile to obtain clarification from the New York Fed. In the event the New York Fed does render such CMBS ineligible, an issuer of TALF-eligible new issue CMBS that also wants to issue floating rate CMBS ultimately backed by the same fixed-rate collateral pool, through the use of an interest rate swap contract, may want to consider using a second trust fund (*i.e.*, effect a resecuritization of the subject CMBS). The foregoing issue will also apply where, for cost and efficiency reasons, a mortgage asset that would not constitute a qualifying credit exposure for a TALF-eligible CMBS has been included in a particular trust fund solely with the intent that it would back a particular class of CMBS that is not intended to be pledged to TALF.

Issuer Certifications and Auditor Assurances. The issuer and sponsor of new issue CMBS must include in the related prospectus or other related offering document a signed certification indicating, among other things, that the CMBS is TALF-eligible. According to the General TALF FAQs, the exact framework for the issuer/sponsor certification and a corresponding auditor certification was, as of May 19, 2009, still being developed. In addition, the sponsor — or, if the sponsor is a special purpose vehicle, the sponsor's direct or indirect ultimate parent — must indemnify the New York Fed from any losses it may suffer if such certifications are untrue. In light of the greater number of underlying asset requirements for new issue CMBS, in addition to the greater complexity of such underlying assets, as compared to most other types of TALF-eligible collateral, it would appear that CMBS issuers and sponsors may be exposed to greater TALF-related risks — both to investors under applicable securities laws and to the New York Fed under the indemnity thereto — than issuers and sponsors of other TALF-eligible collateral.

In addition, the New York Fed will require the sponsor of new issue CMBS to retain a nationally-recognized certified public accounting firm that is registered with the Public Company Accounting Oversight Board to provide assurance indicating that a new issue CMBS is TALF-eligible. The New York Fed has indicated that it is currently reviewing the form and level of assurance to be required.

Neither the TALF (Legacy CMBS) Terms and Conditions nor the TALF (Legacy CMBS) FAQs imposes, or offers any guidance regarding, an issuer certification or auditor assurance requirement with respect to legacy CMBS.

Governing Documents

New Issue CMBS. According to the General TALF Terms and Conditions, "[t]he pooling and servicing agreement and other agreements governing the issuance of the [TALF-eligible new issue] CMBS and the servicing of its assets must contain provisions to the following effects:

- If the class of the CMBS is one of two or more time-tranched classes of the same distribution priority, 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.'[11]

[11] An "appraisal reduction amount" is an estimate of the amount, if any, by which a mortgage loan is undercollateralized, based upon, among other things, a recent valuation of the related real estate collateral, as reduced by a haircut generally equal to 10% of such valuation. Appraisal reduction amounts have commonly been used in shifting control or triggering a change in payment terms in a split loan structure involving multiple promissory notes secured by the same mortgage instrument(s) encumbering the same real estate collateral or in a single-loan participation structure.

It is a common practice for the holders of subordinate promissory notes and participations to retain control rights by offsetting appraisal reduction amounts through the posting of additional collateral, such as cash and/or letters of credit, with the securitization trustee. However, given the New York Fed's aversion to the inclusion of securities in the trust fund and, as described below, the use of guarantees to support ratings on TALF-eligible CMBS, it is possible that the New York Fed would not allow appraisal reduction amounts to be so offset at all or, if it does permit the posting of additional collateral, it may permit offsets solely with cash or U.S. Treasury securities.

- Control over the servicing of the 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.'[12]

- A post-securitization property appraisal may not be recognized for any purpose under such agreements 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.[13]

- The mortgage loan seller must represent that, upon the origination of each underlying mortgage loan, the improvements at each related property were in material compliance with applicable law."

In addition, the New York Fed has stated in the General TALF Terms and Conditions that it "expects the agreements governing the issuance of each [new issue] CMBS and the servicing of its assets, and the terms and conditions of its underlying loans, to permit, and to provide in effect for, reporting that is sufficient to enable the New York Fed to monitor and evaluate its position as secured lender." One would anticipate that the standardized investor reporting package of the Commercial Mortgage Securitization Association (the "CMSA") would be acceptable for this purpose but specific guidance has not yet been provided.

Legacy CMBS. At this time the New York Fed has not required that the pooling and servicing agreement and other agreements governing the issuance of TALF-eligible legacy CMBS and the servicing of its assets contain provisions similar to those set forth above. Nonetheless, it is quite common for the governing documents in respect of a legacy CMBS to provide that:

- If a class of the CMBS is one of two or more time-tranched classes of the same distribution priority, 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 solely actual realized losses.

- Control over the servicing of the underlying mortgage assets, whether through approval, consultation or servicer appointment rights, may 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 solely actual realized losses.

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[12] At this time the New York Fed has not specifically addressed how to allocate control over the servicing of a split loan structure or a participated mortgage loan — whether through approval, consultation or servicer appointment rights — between (i) a promissory note from such split loan structure or a participation interest in such participated mortgage loan, as applicable, that is held in a TALF-eligible CMBS trust fund, and (ii) a related promissory note or participation interest, as applicable, that is held outside such trust fund. By analogy it appears that control could not reside in an outside the trust subordinate loan interest once its principal balance is reduced, including by reason of the allocation of appraisal reduction amounts, to 25% or less of its initial principal balance. However, many co-lender agreements and participation agreements provide for a change in control when the principal balance of the subordinate loan interest is reduced to 25% or less of an amount equal to its initial principal balance net of payments of principal in reduction thereof received through the date of determination. In addition, in situations where the outside the trust loan interest is a *pari passu* loan interest, joint control or split control over various servicing actions for the life of the loan would not be uncommon. In the event the New York Fed views split loan structures as constituting separate mortgage loans, and accordingly permits contractually subordinate mortgage notes to back legacy CMBS, further questions would arise where a senior outside the trust loan interest gains control over certain servicing actions following the occurrence of an appraisal or other control trigger event with respect to the subordinate note in the trust.

[13] The General TALF FAQs have made it clear that no other party (for example, the holder of a subordinate promissory note serviced under the applicable pooling and servicing agreement but not held by the CMBS trust fund) may obtain a competing appraisal to challenge the servicer's or trustee's appraisal.

- The related mortgage loan seller must represent that, among other things, upon the origination of each underlying mortgage loan, the improvements at each related property were in material compliance with applicable law.

- Investors in the CMBS will receive the CMSA's standardized investor reporting package.

Characteristics of the CMBS

Required Characteristics. In order to qualify as eligible collateral for a TALF loan, both a new issue CMBS and a legacy CMBS:

- must, as of the TALF loan closing date, have a credit rating in the highest long-term investment grade rating category from at least two (2) TALF CMBS-eligible rating agencies and may not have a credit rating below the highest investment-grade rating category from any TALF CMBS-eligible rating agency;[14]

- must entitle its holders to payments of principal and interest (that is, must not be an interest-only or principal-only security);

- must bear interest at a pass-through rate that is fixed or based on the weighted average of the underlying fixed mortgage rates;[15]

- must not be, in the case of new issue CMBS, or have been upon issuance, in the case of legacy CMBS, junior to other securities with claims on the same pool of loans;[16]

- may not be issued by an agency or instrumentality of the United States or a government-sponsored enterprise; and

- must be cleared through the Depository Trust Company.

No IOs or POs. The New York Fed has stated that the pledged CMBS must entitle its holders to payments of principal and interest. However, it has not addressed whether CMBS — regardless of whether it is new issue CMBS or legacy CMBS — will be TALF-eligible if it consists of multiple components or if it provides for disproportionate payments of interest relative to principal or vice versa. For example, certain CMBS can be structured to be a combination of (i) an interest-only security that accrues interest on a notional principal balance that is unrelated to its principal amount and (ii) a principal-only security. Alternatively, the CMBS can have a principal amount on which a nominal amount of interest accrues at a minimal pass-through rate or nominal principal amount on which interest accrues at an extremely high pass-through rate. Being too aggressive in structuring could result in rejection of the resulting CMBS as collateral for a TALF loan.

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14 The required ratings may not be based on the benefit of a third-party guarantee and may not have been placed, as of the TALF loan closing date, on review or watch for downgrade by any TALF CMBS-eligible rating agency. The TALF CMBS-eligible rating agencies are DBRS, Inc., Fitch Ratings, Moody's Investors Service, Realpoint LLC and Standard & Poor's. As is the case with other types of TALF-eligible ABS, subsequent downgrades of the required ratings on TALF-eligible CMBS will have no effect on existing TALF loans.

15 Although the TALF (Legacy CMBS) Terms and Conditions do not require that all the mortgage loans backing a legacy CMBS bear interest at fixed mortgage rates, it would be unlikely for a legacy CMBS with the required pass-through rate to evidence an interest in a trust fund consisting of floating rate commercial mortgage loans.

16 The New York Fed has clarified that the reference to "junior" is meant to be a reference to subordination for credit support, and not to a later position in the time tranche sequence of two (2) or more time-tranched classes of the same distribution priority.

No Subordinate Securities are TALF-Eligible Collateral. Only AAA-rated senior CMBS can be TALF-eligible collateral. Accordingly, issuers will still be faced with marketing, and investors will still be faced with reselling, the somewhat illiquid subordinate CMBS without any outside financial assistance. This subordinate CMBS will likely command high yields, which (in the case of new issuances) will, in turn, drive up the cost to mortgage borrowers of such financing. Furthermore, because credit support levels for new issue CMBS are likely to be higher in the current economic environment, issuers should expect proportionately more subordinate CMBS to market.

Loan Terms, Haircuts and Other Conditions

Loan Terms. In general, the TALF loan amount for any pledged ABS — including new issue CMBS, but excluding legacy CMBS — will equal (i) the lesser of the par or market value of the pledged ABS, minus (ii) the applicable collateral haircut. Alternatively, when the pledged ABS has a market value above par, the New York Fed will lend an amount equal to (i) the market value, subject to a cap of 110% of par value, minus (ii) the applicable collateral haircut, and the borrower will periodically prepay a portion of the loan. For collateral priced at a premium to par, the borrower will be required to make additional principal prepayments calculated to adjust for the expected reversion of market value toward par value as the ABS matures. For purposes of the foregoing, the amount of the applicable collateral haircut will equal the product of (x) the amount described in clause (i) of either the first sentence of this paragraph or the second sentence of this paragraph, as applicable, multiplied by (y) the applicable collateral haircut percentage described under "—Haircut Percentages and Average Lives" below.

The TALF loan amount for each legacy CMBS will equal: (i) the dollar purchase price (*i.e.*, the current market price) of the CMBS; minus (ii) the applicable base dollar haircut (from par). In contrast to the formula for other ABS, including new issue CMBS, the base dollar haircut percentage for legacy CMBS described under "—Haircut Percentages and Average Lives" below is applied to the par amount of the pledged legacy CMBS rather than any lower market value as described in the preceding paragraph. The base dollar haircut percentage is the equivalent of a collateral haircut percentage equal to the amount of the base dollar haircut divided by the current market price. The examples provided in the TALF (Legacy CMBS) FAQs to illustrate the foregoing are as follows, and assume a legacy CMBS with a par value of $100 and a seven-year weighted average life, with a base dollar haircut of 17% of par:

- if the market price of the pledged legacy CMBS is 75% of par, then the loan amount is $58 (*i.e.*, $75 minus $17) and the collateral haircut is 23% of the market price (*i.e.*, $17 divided by $75); and

- if the market price of the pledged legacy CMBS is 50% of par, then the loan amount is $33 (*i.e.*, $50 minus $17) and the collateral haircut is 34% of the market price (*i.e.*, $17 divided by $50).

A legacy CMBS will not be eligible collateral for a TALF loan if its dollar purchase price is less than its base dollar haircut.

Each TALF loan secured by a CMBS will have a three-year maturity or a five-year maturity, at the election of the borrower. A three-year TALF loan will bear interest at a fixed rate per annum equal to 100 basis points over the three-year LIBOR swap rate. A five-year TALF loan will bear interest at a fixed rate per annum equal to 100 basis points over the five-year LIBOR swap rate.

Haircut Percentages and Average Lives. The collateral haircut percentage for each TALF-eligible new issue CMBS with an average life of five years or less, and the base dollar haircut percentage for each TALF-eligible legacy CMBS with an average life of five years or less, will each be 15%. For TALF-eligible CMBS with average lives beyond five years, collateral haircut percentages and base dollar haircut percentages will both increase by one percentage point for each additional year of average life beyond five years. No new issue TALF-eligible CMBS may have an average life beyond ten years. At this time the New York Fed has not set a maximum average life for legacy CMBS.

According to the General TALF Terms and Conditions, the average life of a TALF-eligible new issue CMBS will be "the remainder of the original weighted average life determined by its issuer employing industry-standard assumptions." The General TALF FAQs further clarifies that the weighted average life for new issue CMBS is "based on the assumption that each loan amortizes according to its amortization schedule and prepays in full on the first date that prepayment is permitted without penalty."

The TALF (Legacy CMBS) Terms and Conditions states that the average life of a legacy CMBS will be "the remainder of the original weighted average life determined by its issuer, with certain adjustments." According to the TALF (Legacy CMBS) FAQs, "[t]he New York Fed is considering requiring that default-related circumstances be considered in calculating the weighted average life of a legacy CMBS." Ironically, depending on the assumptions regarding default rate, the period between default and liquidation and loss severity, such default-related adjustments to weighted average life might result in a shorter average life and, accordingly, a smaller haircut.

Repayment of TALF Loans. Unless otherwise provided in the Master Loan and Security Agreement, any remittance of principal on pledged CMBS — regardless of whether it is new issue CMBS or legacy CMBS — must be used immediately to reduce the principal amount of the related TALF loan in proportion to the haircut. For example, if the haircut was 15%, 85% of any remittance of principal on the pledged CMBS must immediately be repaid to the New York Fed. However, neither the TALF (Legacy CMBS) Terms and Conditions nor the TALF (Legacy CMBS) FAQs specifies whether, for legacy CMBS, the specified percentage is the related base dollar haircut percentage or the equivalent collateral haircut percentage.

In addition, for a five-year TALF loan secured by either new issue CMBS or legacy CMBS, the excess of pledged 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 haircut amount in the first three loan years, 10% in the fourth loan year, and 5% in the fifth loan year, and the remainder of such excess will be applied to TALF loan principal. For purposes of the foregoing, interest distributions are to be monitored monthly, and any excess interest distributions are to be applied to loan repayments monthly. The calculations of excess interest distributions will be based on the current, rather than the original, haircut amount.

Furthermore, for a three-year TALF loan secured by legacy CMBS (but apparently not by new issue CMBS), the excess of pledged CMBS interest distributions over TALF loan interest payable will be remitted to the TALF borrower in each loan year until it equals 30% *per annum* of the haircut amount, with the remainder of such excess to be applied to loan principal.

Surrender of Voting Rights. A TALF borrower must agree not to exercise or refrain from exercising any voting, consent or waiver rights under a pledged CMBS — regardless of whether it is new issue CMBS or legacy CMBS — without the consent of the New York Fed.

Issuer/Sponsor/Originator Restriction

According to the General TALF Terms and Conditions, eligible collateral for a particular TALF borrower (including CMBS collateral) may not be backed by loans originated or securitized by such borrower or by an affiliate of such borrower.[17] Other TALF pronouncements, such as the general form of "Certification as to TALF Eligibility" that is required to be included in the related offering document in order for securities to be TALF-eligible, expand the restriction to TALF borrowers also not being sponsors or affiliates of sponsors. Such pronouncement provides that the issuer and sponsor of the subject ABS must include in the related prospectus or other related offering document a signed certification indicating that "... purchasers of the securities offered hereby that are affiliates of either the originators of assets that are securitized in this offering or the issuer or sponsor of this offering will not be able to use these securities as TALF collateral." The exact form of such certification for new issue CMBS is still under consideration by the New York Fed.

Ability to Reserve TALF Funding Capacity for New Issue CMBS

The New York Fed has stated that it may permit interested issuers, through a process to be determined, to reserve prospective funding of TALF loans collateralized by new issue CMBS. The New York Fed expects that each potential issuer that applies for and is awarded such a reservation will pay a monthly reservation fee, calculated as a fraction of the amount reserved, while such reservation is outstanding. Of course, any funding of a TALF loan in connection with such a reservation will be subject to satisfaction of all of the requirements of the TALF program relating to eligible collateral and eligible borrowers. No reservation will extend beyond the last CMBS subscription. If the New York Fed implements this reservation program, details of the process will be announced shortly.

Further Considerations with Respect to Legacy CMBS

According to the TALF (Legacy CMBS) Terms and Conditions, the New York Fed:

- may limit the volume of TALF loans secured by legacy CMBS;[18] and
- 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."[19]

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[17] The General TALF FAQs defines "affiliate of the borrower" to mean "... any company that controls, is controlled by, or is under common control with the borrower. For this purpose, a person or company controls a company if, among other things, it (1) owns, controls, or holds with power to vote 25 percent or more of a class of voting securities of the company; or (2) consolidates the company for financial reporting purposes."

[18] The New York Fed is considering whether to allocate such volume pursuant to an auction or other procedure.

[19] The New York Fed is considering a process for price validation of such secondary market transactions.

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