New York Law Journal

SERVING THE BENCH AND BAR SINCE 1888

WWW.NYLJ.COM



An incisivemedia publication

VOLUME 241—NO. 81

WEDNESDAY, APRIL 29, 2009

**STIMULUS EFFORTS**

Expert Analysis

# Programs Designed to Ease Real Estate Credit Markets

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In recent months, the federal government, through the U.S. Department of the Treasury, the New York Federal Reserve Bank and the Federal Deposit Insurance Corporation has announced and/or implemented a variety of stimulus programs to resurrect the credit markets. Certain of these programs, principally the Term Asset-Backed Securities Loan Facility ("TALF") and the Public-Private Investment Program ("PPIP"), are designed in whole or in part to bring life to the real estate credit markets either by stimulating new lending or by helping financial institutions clear their books of existing loans so that they are better able to resume normal lending practices. This article outlines the principal terms of TALF, as it will ultimately relate to certain residential mort-gage-backed securities ("RMBS") and commercial mortgage-backed securities ("CMBS"), and PPIP.

## TALF

On April 14, the New York Fed settled the second round of loans made under TALF, a lending program designed to jump-start consumer and small business lending by providing non-recourse government loans to investors who purchase asset-backed securities ("ABS") backed by auto loans, student loans, credit card loans, equipment loans, servicing advance receivables and small business loans.

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Since early February, it has been expected that TALF would be extended to the CMBS markets. As part of the March 23 announcements related to PPIP (see discussion below), Treasury announced that TALF would be made available for purchases of certain legacy (i.e., pre-2009) non-agency RMBS and CMBS originally rated AAA, though no mention was made of newly issued RMBS or CMBS.

The efficacy of these programs, their impact on current credit conditions and the amount of government funding and credit support that will be made available all remain uncertain. However, it is certainly the expectation of Treasury and the New York Fed that these programs will be important weapons in the arsenal of financial crisis rescue efforts being unveiled by the government.

It has been reported that the New York Fed has been consulting with the commercial real estate industry over the terms and conditions under which TALF will be made available for the purchase of RMBS and CMBS. No announcement of those terms and conditions had been made as of the date this article was submitted for publication. Given tightening underwriting requirements in the capital markets and the sharp decline in real estate values, it remains to be seen whether TALF will be effective to jump-start the RMBS/CMBS markets without other debt or equity being available to fill the gap in the capital stack.

The following summary of TALF relates to the program in its current, non-RMBS/CMBS form, and certain terms will presumably be modified in the RMBS/CMBS context:

**Structure.** Under the TALF program, the New York Fed extends loans fully secured by eligible collateral (see discussion below). The loans are generally recourse only to the pledged collateral, except in limited circumstances due to breaches of certain representations, warranties and covenants of the borrower. The amount loaned by the New York Fed for each TALF loan equals the market value of the collateral minus a haircut, and interest is payable monthly. The loans generally have a three-year term, though there is pressure on the New York Fed to lengthen the term of the loans backed by RMBS and CMBS to at least five years, given that the term of the underlying ABS would generally be expected to be five years or more. If longer-term loans are offered in the RMBS/CMBS context, incentives will likely be structured into the loans to refinance the TALF loan during the extended portion of the term. TALF loans are prepayable without penalty at the option of the borrower, but substitution of collateral during the term of the loans is not permitted. Any remittance of principal on collateral must be used immediately to pay down principal of the TALF loan.

Borrowers will be able to choose either a fixed or floating interest rate on the loans (floating-rate loans will be based on spreads varying according to the type of pledged collateral). The New York Fed sets the interest rates on the loans so as to provide borrowers an incentive to purchase eligible ABS at yield spreads lower than those prevailing in the highly illiquid conditions that have developed during the recent turmoil in the financial markets.

In the event a borrower does not repay its loan, the New York Fed will enforce its rights in the collateral and sell the collateral to a special purpose vehicle established by the New York Fed to purchase and manage any assets it acquires under TALF.

**Eligible borrowers.** All U.S. companies that own eligible collateral may participate, provided they maintain an account relationship with a primary dealer (i.e., a large, money center dealer bank). A U.S. company is (i) a business entity or institution that is organized under U.S. law or the laws of its territories and political subdivisions ("U. S.-organized") and conducts significant operations or activities in the U.S., including any U.S organized subsidiary of such an entity, (ii) a U.S. insured depository institution, (iii) a U.S. branch or agency of a foreign bank (other than a foreign central bank) that maintains reserves with a Federal Reserve Bank or (iv) an investment fund that is U.S. organized and managed by an investment manager that has its principal place of business in the United States. A "U.S. company" excludes any entity (other than a U.S. insured depository institution or a U.S. branch or agency of a foreign bank) that is controlled by a foreign government or is managed by an investment manager (other than a U.S. insured depository institution or a U.S. branch or agency of a foreign bank) that is controlled by a foreign government.

**Eligible collateral.** Borrowers may use U.S. dollar-denominated cash ABS that have a credit rating in the highest investment-grade rating category from two or more rating agencies and do not have a rating below the highest investment-grade rating category from a rating agency. Currently, the eligible ABS must be backed by certain auto loans, student loans, credit card loans, equipment loans, servicing advance receivables or small business loans. Eligible collateral for a particular borrower must not be backed by loans originated by the borrower or by an affiliate of the borrower.

**Haircuts.** The New York Fed will determine collateral haircuts for each class of eligible collateral based on the price volatility of each such class and the maturity of the eligible collateral pledged. Haircuts currently range between 5 and 16 percent of the loan amount.

**Primary dealers.** Each borrower must use a primary dealer as its agent to access TALF and must deliver eligible collateral to a custodian. Primary dealers are expected to collect, aggregate, and submit loan requests on behalf of their customers, similar to the role they perform at Treasury auctions.

## Public-Private Investment

On March 23, Treasury released details regarding the proposed establishment of public-private investment funds ("PPIFs"), which would be formed to purchase both certain existing loans (initially expected to comprise only residential and commercial real estate loans) held directly on banks' balance sheets ("legacy loans") and existing securities backed by real estate loan portfolios held by financial institutions ("legacy securities").

**Legacy Loans Program.** Under this program, the FDIC will oversee the creation and operation of multiple PPIFs to purchase legacy loans from insured banks and thrifts. The equity in the PPIFs will be funded by private investors and up to 50 percent by Treasury. The purchasing PPIF will be able to borrow a portion of the purchase price by issuing non-recourse debt which is guaranteed by the FDIC, with leverage not to exceed a 6-to-1 debt to equity ratio. The debt will be issued either to the selling institution or to a third party lender, and the guarantee will be secured by the purchased legacy loans. If, in the case of a particular acquisition, the government participates to the maximum extent that is contemplated (through equity contributions and a debt guarantee), the private investor in the PPIF will put at risk approximately 7 percent of the purchase price of the acquired legacy loans.

Investors will bid for the opportunity to invest in legacy loans through an auction program run by the FDIC. Once asset pools are identified by eligible banks and their regulators, the FDIC will conduct due diligence, prepare marketing materials and engage a third party firm to advise on appropriate leverage for the PPIF and to represent the government in structuring the auction. Prior to the submission of bids, investors will be advised of the maximum leverage to be guaranteed by the FDIC and the terms of the guaranteed debt. Potential investors will have to be qualified by the FDIC to participate in the auction. In their bid submissions, bidders will specify the total amount of equity to be contributed by the private investors and Treasury, respectively. The auction rules will require a refundable deposit from each bidder equal to 5 percent of the "bid value."

After bids are submitted, the FDIC will select the highest bidder based on the "cash equivalent price" implied by the bid. The seller will then be permitted to accept or reject the bid and, if the bid is accepted, the seller will receive from the PPIFs a combination of cash and, if the seller is to be the lender of the debt-financed portion of the purchase price, FDIC guaranteed debt. Once purchased, the loans will be serviced, subject to FDIC oversight, by the asset manager chosen by the private investor.

In connection with the giving of its guaranty and its oversight of the auction process, the FDIC will receive guaranty fees, administrative fees and expense reimbursement. Treasury will receive warrants in the PPIF. The amounts of the fees and the terms of the warrants have not yet been announced.

**Legacy Securities Programs**. Under the Legacy Securities Program, PPIFs will be formed to invest in eligible "legacy securities"—a category that will initially include only U.S. residential and commercial mortgage-backed securities issued prior to 2009 that were originally rated AAA or the equivalent without regard to rating enhancement. The categories of eligible sellers of the legacy securities have yet to be identified.

In implementing this program, Treasury will work with at least five private fund managers to be chosen on the basis of announced criteria, including demonstrated capacity to raise at least $500 million in private capital and at least $10 billion of eligible legacy securities under management (although Treasury has indicated that failure to meet any one criteria will not preclude a manager from being selected). A private investment vehicle controlled by the applicable fund manager and Treasury will be the sole investors in each PPIF, with Treasury contributing 50 percent of the equity of the PPIF and with the PPIF being managed—subject to reporting and oversight by Treasury—by the fund manager. Investors in the private investment vehicle will be required to agree to at least a three-year lock-up (although Treasury may require longer periods). With respect to debt financing for PPIFs acquiring legacy securities, Treasury is considering three possible debt arrangements involving a combination of loans under the TALF or other Treasury programs, direct secured or unsecured financing from the Treasury and loans from private sources.

In addition to the returns on its debt and equity investment, Treasury will receive warrants the terms of which will be determined in part based on the amount of debt issued by the government.

### Open Questions

Treasury has not yet offered detailed guidance on how the TALF program will be applied to the RMBS and CMBS markets, or how the PPIFs will function in practice. Among the key open questions are the following:

• Will the TALF program be available both for legacy RMBS/CMBS and for newly issued RMBS and CMBS?

• Other than the loan term,which is expected to be longer in the real estate context, how will the TALF terms and conditions for real estate-related loans differ from the existing TALF program terms and conditions?

• What will be the mechanicsof the PPIF auction process for legacy loans? What opportunities will there be to conduct due diligence, and how much time will private investors have to raise their equity funding?

• What categories of private investors will be permitted to participate in the PPIFs?

• Will the PPIFs bid prices high enough to interest the holders of the legacy assets in selling? Will the recent liberalization of the mark-to-market accounting rules increase holders' resistance to reducing prices to levels the PPIFs are willing to pay?

• Will there be limits on executive compensation? Because PPIP is part of the Troubled Asset Relief Program ("TARP") enacted last fall, the executive compensation restrictions imposed by TARP may apply. Although the FDIC and Treasury have indicated that passive private investors will not be subject to the restrictions, the extent to which the restrictions will apply to investment managers or their employees or affiliates is unclear.

• In light of recent controversies over private sector compensation generally, will profits derived by the PPIFs from the legacy assets be subject to public criticism or attempted special taxation?

• Under the legacy securities program, Treasury will expressly reserve the right to "cease funding of committed but undrawn Treasury equity capital and debt financing in its sole discretion." Will this right make it difficult to raise private capital for PPIFs, if investors become sufficiently concerned about Treasury's inability or unwillingness to contribute its share of the purchase price for the legacy assets?

• What level of oversight will the government exercise over the managers of PPIFs?

• PPIFs will be subject to certain reporting requirements, and access to books and records must be provided to various government agencies. What will the scope of this disclosure be?

### Conclusion

Both the TALF and the PPIP are works in progress, and there is little doubt that they will evolve in response to public comment and actual experience. The efficacy of the programs, their impact on current credit conditions and the amount of government funding and credit support that will be made available all remain uncertain. However, it is certainly the expectation of the Treasury and the New York Fed that these programs will be important weapons in the arsenal of financial crisis rescue efforts being unveiled by the government.