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February 13, 2009

TO: Commercial Mortgage Securities
Association

FROM: Scott A. Sinder
Rhonda M. Bolton

RE: Terms and Conditions for Participation in the Term Asset-Backed Securities
Loan Facility (TALF)

Overview

You have asked for details concerning the terms and conditions for participation in the federal government's Term Asset-Backed Securities Loan Facility (TALF), which was expanded this week to include commercial mortgage-backed securities ("CMBS"), and will become part of the "Consumer & Business Lending Initiative" prong of the Obama Administration's "Financial Stability Plan."¹ As described below, under the current set of Terms and Conditions for TALF, executive compensation and public reporting requirements will not be required for investors

¹ The Administration has reportedly renamed the Troubled Assets Relief Program ("TARP") the "Financial Stability Plan." For ease of reference, we will continue to refer to the programs here as TARP and TALF. The Treasury Department fact sheet concerning the Financial Stability Plan is available at <http://www.treas.gov/news/index2.html>.

seeking to borrow money under the program. However, *sponsors* of the asset-backed securities (“ABS”) issuances used as collateral under TALF will be required to comply with executive compensation limits set forth in the Troubled Assets Relief Program (“TARP”).²

TARP’s compensation limits and reporting requirements have received much attention recently. Modifications to strengthen these obligations were proposed by the Treasury Department on February 4, 2009,³ but Treasury’s modification announcement states that the new rules will not be retroactive and are not intended to apply to existing programs, including TALF.⁴

Thus, the executive compensation rules that will apply to ABS sponsors under TALF will require that sponsors:

² The creation of TALF was originally announced in November 2008 and a term sheet was released at that time, and amended in December 2008. The term sheet was modified again on February 6, 2009 and the terms and conditions described here are taken from the February 2009 term sheet unless indicated otherwise. The February 2009 term sheet is available at http://www.newyorkfed.org/markets/talf_terms.html. Because the Federal Reserve has retained the right to make modifications to the TALF terms and conditions at any time, entities considering participation in TALF should check for updates so that their decisions are informed by the most current information regarding the program.

³ As part of the Financial Stability Plan, Treasury also announced new restrictions on payment of dividends exceeding \$0.01, re-purchase of shares, and the acquisition of healthy firms. The scope of these restrictions is not completely clear from the information provided by Treasury thus far on the Financial Stability Plan. But the most logical reading of it is that these additional restrictions apply only to entities such as banks that accept direct capital injections from Treasury, and not to TALF (unless, of course, a TALF participant is a bank that has received a direct capital injection).

⁴ See <http://www.treasury.gov/press/releases/tg15.htm>. A caveat to any discussion of executive compensation rules or other obligations associated with federal assistance is the possibility that Congress might impose stricter, or different, rules that override any adopted by Treasury. Most recently, very strict compensation caps were added to the Senate’s version of the economic stimulus bill. These caps have reportedly been cut from the final version of the legislation, a fact that some regard as an indication that it would be difficult to get another executive compensation bill through Congress. But given the public’s high level of sensitivity about the issue, the possibility of stricter future executive compensation limits should not be completely discounted. In short, executive compensation rules warrant continued monitoring for new developments

- Review and certify that the top five executives' compensation arrangements did not encourage excessive and unnecessary risk-taking; there are no limits on compensation amounts;
- Adopt clawback provisions applicable to the company's top five executives for any that are found to have knowingly engaged in providing inaccurate information relating to financial statements or performance metrics used to calculate their own incentive pay; and
- Limit golden parachutes for the top five senior executives to no more than three years' compensation.

As for public reporting requirements for TALF, the scope of any such obligations is somewhat unclear. The original TALF term sheet did not describe any particular reporting obligations applicable to originators or investors, although it is wise to assume that at least some aspects of TALF transactions will be made public, such as borrower names and loan amounts, consistent with the expectations imposed upon other TARP-related programs.

However, certain new reporting obligations to be imposed by the Financial Stability Plan state that they will apply to "all recipients of assistance," without specifying further whether this means assistance under capital injection programs (which is the subject of most of Treasury's discussion concerning public reporting) or whether it means all types of assistance. The most logical reading of the information provided by Treasury is that the reporting obligations apply to entities receiving direct capital investment from Treasury.

But if this interpretation proves incorrect, potential TALF participants should be aware that the new public reporting obligations include, among other things, reports by recipients on the number of securities they purchased with government funds (or in the case of banks, how many loans they made), with an analysis of "what their lending would have been in the absence

of government support.” At present, Treasury has not provided information concerning whether it will accommodate any concerns about disclosure of proprietary information.⁵

General TALF Program Description

The TALF’s creation was announced in November 2008, but it has not yet been implemented. The latest guidance from the Federal Reserve is that the agency will announce a start date for TALF in February 2009. The program’s original stated purpose is to “assist the credit markets in accommodating the credit needs of consumers and small businesses by facilitating the issuance of asset-backed securities (“ABS”) and improving the market conditions for ABS more generally.” TALF is a joint initiative of Treasury and the Federal Reserve. With this week’s funding changes to the program, the Federal Reserve Bank of New York (“FRBNY”) will make up to \$1 trillion of loans, and Treasury will provide \$100 million from the TARP as credit protection for the loan facility. The facility will cease making new loans on December 31, 2009, unless the Federal Reserve Board agrees to extend the facility.

1. Loan Terms

TALF loans will have a three-year term, will be non-recourse to the borrower, and will be fully secured by eligible asset-backed securities. Treasury states that the term of TALF loans may be lengthened later “if appropriate.” Substitution of collateral during the term of the loan will not be permitted.

Interest on TALF loans will be payable monthly. Borrowers will be able to choose either a fixed or floating interest rate on TALF loans. The fixed interest rate will be 100 basis points

⁵ As is the case for executive compensation limits, potential TALF participants should be aware that Congress could impose broader, or different, reporting or disclosure obligations than those currently imposed by the Treasury Department, although at this time we are not aware of any such proposals that have gained traction in Congress.

over the 3-year Libor swap rate, and the floating interest rate will be 100 basis points over 1-month Libor. The FRBNY also will assess an administrative fee equal to 5 basis points of the loan amount on the settlement date of each loan transaction.

TALF loans will not be subject to mark-to-market or re-margining requirements. And TALF loans will be pre-payable in whole or in part at the option of the borrower.

Any remittance of principal on eligible collateral must be used immediately to reduce the principal amount of the TALF loan in proportion to the loan's original loan-to-value ratio (e.g., if the original loan-to-value ratio was 90 percent, 90 percent of any remittance of principal must immediately be repaid to the FRBNY).

2. Eligible Collateral

Eligible collateral will include U.S. dollar-denominated cash (that is, not synthetic) ABS that have a long-term credit rating in the highest investment-grade rating category (for example, AAA) from two or more major nationally recognized statistical rating organizations ("NRSROs") and do not have a long-term credit rating of below the highest investment-grade rating category from a major NRSRO.

Additionally, only ABS that are cleared through the Depository Trust Company will be eligible.

With the exception of certain SBA-related ABS, eligible ABS must be issued on or after January 1, 2009. The underlying credit exposures of eligible ABS must be commercial mortgage-backed securities, auto loans, student loans, credit card loans, or small business loans guaranteed by the U.S. Small Business Administration. The set of permissible underlying credit exposures of eligible ABS may be expanded later to include non-Agency residential mortgage-backed securities or other asset classes. The underlying credit exposures must not include

exposures that are themselves cash or synthetic ABS. Eligible collateral for a particular borrower must not be backed by loans originated by the borrower or by an affiliate of the borrower.

All or substantially all of the credit exposures underlying eligible ABS must be “newly or recently originated” exposures to U.S.-domiciled obligors. Accordingly, there are date of origination restrictions for the credit exposures underlying the various types of eligible ABS. The date of origination restriction for CMBS has not yet been announced. However, to provide a frame of reference, the origination date for auto loans underlying eligible ABS is on or after October 1, 2007, and that for student loans underlying eligible ABS is May 1, 2007.

3. Executive Compensation Restrictions

The sponsor, as such term is defined in 17 C.F.R. § 229.1101 (Regulation AB), of the eligible ABS (or the applicable entity specified in forthcoming TALF certification documents) must have agreed to comply with, or already be subject to, the executive compensation requirements in section 111(b) of the Emergency Economic Stabilization Act of 2008. As implemented by the Treasury Department, these rules require that participating companies:

- Review and certify that the top five executives’ compensation arrangements did not encourage excessive and unnecessary risk-taking; there are no limits on compensation amounts;
- Adopt clawback provisions applicable to the top five executives for any that are found to have knowingly engaged in providing inaccurate information relating to financial statements or performance metrics used to calculate their own incentive pay; and
- Limit golden parachutes for the top five senior executives to no more than three years’ compensation.

Treasury has stated that it does not intend for the stricter rules it announced on February 4, 2009 to apply to TALF. The Federal Reserve has specifically advised that the executive compensation requirements will not be applied to borrowers under TALF.⁶

4. Reporting and Disclosure Requirements

The TALF terms and conditions do not describe any particular reporting obligations applicable to originators or investors. However, it is safe to assume that once the TALF program commences, at least some aspects of TALF transactions will be made public, such as borrower names and loan amounts, consistent with the expectations imposed upon other programs related to TARP.

It should be noted that certain new reporting obligations to be imposed by the Financial Stability Plan state that they will apply to “all recipients of assistance,” without specifying further whether this means assistance under capital injection programs (which is the subject of most of Treasury’s discussion concerning public reporting) or whether it means all types of assistance. The most logical reading of the information provided by Treasury is that the reporting obligations apply to entities receiving direct capital investment from Treasury. But if this interpretation proves incorrect, potential TALF participants should be aware that the new public reporting obligations include, among other things, reports by recipients on the number of securities they purchased with government funds (or in the case of banks, how many loans they made), with an analysis of “what their lending would have been in the absence of government support.” Treasury has not yet provided information concerning whether it will accommodate recipients’ concerns about disclosure of proprietary information.

⁶ See http://www.newyorkfed.org/markets/talf_faq.html.

As is the case for executive compensation limits, potential TALF participants should be aware that Congress could impose broader, or different, reporting or disclosure obligations than those currently imposed by the Treasury Department. There is, for example, a Senate bill that has been introduced that would require recipients of TARP assistance to open their books and records to inspection by the Government Accountability Office. But the likelihood of such a proposal gaining traction is presently unclear.

5. Borrower Eligibility

Any “U.S. company” that owns eligible collateral may borrow from the TALF, provided the company maintains an account relationship with a primary dealer. A “U.S. company” for TALF purposes is:

- a business entity or institution that is organized under the laws of the United States or a political subdivision or territory thereof (U.S.-organized) and conducts significant operations or activities in the United States; this includes U.S.-organized subsidiaries of foreign entities.
- 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
- 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.

In no circumstance, however, will any entity that is controlled by a foreign government or is managed by an investment manager controlled by a foreign government be eligible.

6. Transaction Structure

Collateral haircuts will be established by the FRBNY for each class of eligible collateral, and will be determined based on the price volatility of each class of eligible collateral. Haircuts have not yet been announced for CMBS. However, the haircuts for other types of eligible collateral range from 5 percent (e.g., prime credit card loan of less than one year duration) to 16 percent (auto floorplan loan of 4-5 years duration).

The FRBNY will announce monthly TALF loan subscription and settlement dates. On each subscription date, borrowers will be able to request one floating-rate and one fixed-rate TALF loan by indicating for each loan the eligible ABS collateral they expect to pledge, the desired loan amount, and the desired interest rate format (fixed or floating). Loan proceeds will be disbursed to the borrower, contingent on receipt by the FRBNY's custodian bank of the eligible ABS collateral. The minimum size for each TALF loan will be \$10 million.

The FRBNY reserves the right to reject any request for a loan, in whole or in part, in its discretion. In this regard, it will develop and implement procedures to identify for further scrutiny potentially high-risk ABS that a borrower proposes to pledge under the TALF.

Each borrower must use a primary dealer, which will act as agent for the borrower, to access the TALF and must deliver eligible collateral to a clearing bank.

The FRBNY will create a special purpose vehicle ("SPV") to purchase and manage any assets received by the FRBNY in connection with any TALF loans. The FRBNY will enter into a forward purchase agreement with the SPV under which the SPV will commit, for a fee, to purchase all assets securing a TALF loan that are received by the FRBNY at a price equal to the TALF loan amount plus accrued but unpaid interest.

As originally conceived, the TARP program was to purchase subordinated debt issued by the SPV to finance the first \$20 billion of asset purchases, and if more than \$20 billion in assets are purchased by the SPV, the FRBNY would lend additional funds to the SPV to finance such additional purchases. These amounts may be increased in light of the announcement that more funding will be devoted to TALF.

In any event, the framework provides that the FRBNY's loan to the SPV will be senior to the TARP subordinated loan, with recourse to the SPV, and secured by all the assets of the SPV.

All cash flows from SPV assets will be used first to repay principal and interest on the FRBNY senior loan until the loan is repaid in full. Next, cash flows from assets will be used to repay principal and interest on the TARP subordinated loan until the loan is repaid in full. Residual returns from the SPV will be shared between the FRBNY and the U.S. Treasury.

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The TALF Term Sheet advises that the Federal Reserve retains the right to make changes to the terms and conditions, including the size of the program, loan maturity, collateral haircuts, and asset and borrower eligibility requirements. Accordingly, those considering participation in TALF are strongly encouraged to check for and review the most recent TALF term sheet before participating in the program.