

Modifications to the Term Asset-Backed Securities Loan Facility For CMBS

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August 11, 2009

THE ISSUE

The Term Asset-backed Securities Loan Facility (“TALF”) is working well for most asset-backed securities issued since the program was introduced on May 1, 2009. Since the program was introduced there have been 56 deals totaling \$55 billion in total securities issuance and the program is steadily growing. Despite the Federal Reserve’s efforts to include CMBS as eligible collateral under the TALF program, issuance for *newly* originated CMBS loans has not had the same success. While the purchase of legacy CMBS securities using TALF financing has started, the TALF program for newly issued CMBS is off to a slow start with few issues in the pipeline.

TALF has not fueled many new commercial real estate loan originations yet for a variety of reasons, including: i) the program is set to expire on December 31, 2009 and the process of originating a pool of loans and getting them rated takes months; (ii) originating commercial real estate loans without knowing what the ultimate cost of capital will be because of the uncertainties of the TALF program introduces significant warehouse aggregation risk making the securitization-based loan pricing to the borrower unattractive; and (iii) the market is stuck in a period of non-transactional limbo as it attempts to survive a historical price decline from a 6% cap rate environment to a 8.5-9% cap rate environment.

The first two issues can be addressed by making minor modifications to the TALF terms and conditions so as to better accommodate the specifics of the CMBS market, and as a result mortgage spreads should drop and lenders will thus increasing their lending activity. The final issue will resolve itself over time, as loan defaults on legacy loans increase to historical highs forcing the market to deal with the inevitable massive losses that occur when pricing gaps from historical highs to more normal levels.

THE IMPORTANCE OF TALF TO THE COMMERCIAL REAL ESTATE CREDIT MARKETS

TALF is extraordinarily important to the commercial real estate industry. Lending is always dependent upon leverage. For banks, that leverage is provided by deposits. For non-banks, that leverage comes through the securitization process and the sale of senior interests in pools of loans. With the banking system in shambles the deposit-based lending system cannot be expected to provide the crux of the capital needed to fill the needs of the CRE industry, thus placing a significant burden on the securitization-based alternative. However, in the securitization model, the buyers of the senior bonds, who provide lender leverage to securitization-based lenders, themselves rely upon financing to acquire their bonds, and without the positive leverage financing that used to come in the form of Wall Street dealer-provided “Repo” financing, the bond market cannot function at the levels required to satisfy the real estate borrowers’ needs. TALF is the substitute for that “Repo” financing,

and is the oxygen needed to insure that the securitization-based system of finance will operate in a manner and in a scale that is suitable to meet the massive needs of the CRE industry.

Today, there is \$1.4 trillion of commercial mortgage loans scheduled to mature over the next 4 years which is equivalent to \$1.0 billion of loans maturing each day over this period, all of which will need to be refinanced. Overwhelmed with loan maturities and falling property values approaching nearly 40%, lenders and CMBS servicers are left with few alternatives other than to extend loan maturities which is further increasing the stress in the system. The banking system is out of capital and securitization-based lending has never been more needed than it is now. With the absence of a private sector solution to the leverage needs of bond-buyers that had been provided in the past by the investment banks, TALF is critical for the securitization marketplace to be in a position to address the needs of the CRE industry.

RECOMMENDATIONS TO MODIFY THE TERMS OF THE TALF PROGRAM FOR NEWLY ORIGINATED CMBS LOANS

There are two minor modifications to the TALF program that will significantly increase the flow of CMBS loan origination activity and CMBS senior bond buying. First, the TALF program needs to be extended for a minimum time period, ideally 2-3 years but at the very least one year. Second, the definition of “Qualified Borrower” needs to be expanded to include the originators of CMBS loans.

RATIONALE FOR THE RECOMMENDATION

The rationale for both these recommendation is quite simple. Extending the program is logical given that it will take most lenders several months to originate, structure, and securitize a \$500 million pool of loans. The TALF program could expire prior to a securitization coming to market thus leaving the lender significantly exposed. Most lenders will not take that risk. This is why even a one year extension will only impact the origination market through the third quarter of 2010.

By expanding the definition of a Qualified Borrower under the TALF program to include loan originators, lenders could readily pledge the AAA rated components of their loan pools directly in exchange for the 85% TALF financing. In this case the lenders, who own the loans by virtue of the fact that the loan proceeds far exceed the AAA component of the loans, are thus perfectly aligned with the TALF investor’s interest (the NY Fed) *and* a level of intermediation is removed thus enabling the real estate borrower to benefit from a lower cost of capital.

Any and all losses under each individual loan would be borne by the lender before the AAA CMBS bond collateral could be affected, which is no different than if the AAA were sold to a third-party. The Federal Reserve’s risk position is the same whether the TALF loan is extended to a buyer of CMBS bonds or an originator of loans. In both instances the Federal Reserve holds the same collateral package, the ratings process is adhered to, and the collateral conforms to the same identical standards.

In fact, a strong case could be made that the originator of the loan, who will hold the loan to maturity and who knows the loan most intimately, is a much better-qualified borrower from TALF than a bond-buyer who is far removed from any primary understanding of the credit quality of the underlying loans. By extending the TALF credit directly to the loan originator/loan owner, the NY Fed reduces its reliance on the now-suspect credit underwriting capabilities of the rating agencies and shifts it more to the loan originator/owner who has significant skin in the game and who is best equipped and motivated to both insure the loans are of good quality at origination and who will monitor the loans so they perform optimally over their lives.

TALF loans extended to the originators of real estate loans do not appear to pose the same conflict as they do in ABS issuance. In ABS issuance, all the loan collateral is generally rated AAA and sold with no risk retention by the originating lender of the ABS loans. As a result, these lenders retain no “skin in the game,” and are thus engaged in a form of financial arbitrage. Real estate loans, in contrast, typically run up to 75% LTV, while the AAA component is generally limited to the approximate 50% LTV, thus the real estate lender, even after selling the AAA rated bonds, remains on the hook for the junior-most 33% of the loan. This is why the interests of the CMBS investors, and their leverage providers (TALF), and those of the loan originators who create and own the loans that back CMBS would always be perfectly aligned.

CONCLUSION

These minor changes to the current TALF program for newly originated CMBS loans will have a dramatic and long lasting affect on the commercial mortgage market and are essential to stemming further and substantial losses in the commercial real estate industry.

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