Distressed Real Estate

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PPIP and TALF Evolve to Reflect Market Changes

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The Federal Deposit Insurance Corporation's June 3 announcement of the postponement of the Legacy Loans program, which was a key component of the Treasury Department's Public Private Investment Program (PPIP), is not expected to slow the Obama administration's effort to stimulate credit markets through the use of FDIC-guaranteed debt and government equity. The other component of PPIP—the Legacy Securities program—is in the latter stages of development, and the Term Asset-Backed Securities Loan Facility (TALF) has generated significant interest from investors looking for favorably priced debt to acquire asset-backed securities (ABS).

The Legacy Loans program, which was intended to attract private capital to acquire troubled loans from banks, foundered as a result of the ability of many banks to shore up balance sheets through capital raisings, concerns about potential additional regulation of sellers and buyers, and the difficulty of determining appropriate pricing. Some development of the program will continue, but for now, the FDIC will only test the funding mechanism pursuant to sales of assets from banks that are in receivership. Bids are expected to be solicited in July for those sales, which will be conducted in a manner similar to the sales organized by the Resolution Trust Corporation from 1989 through 1995.

PPIP's second component, the Legacy Securities program, though not yet active, is still on track, and, like TALF, is aimed at restarting the market for legacy ABS. This program is designed to draw private capital into secondary securities markets by providing debt financing from TALF and matching private capital raised for dedicated Public-Private Investment Funds (PPIFs). On June 4, Treasury announced that managers of the PPIFs will likely be named by mid-June, after which they will have up to 12 weeks to raise capital. Treasury has narrowed the list of potential managers to fewer than 20, and now plans to select 5 to 10 initially.

In contrast to the Legacy Loans and Legacy Securities programs, the TALF program—overseen by both the Federal Reserve and Treasury—is operational. The general plan for TALF was announced in

November 2008, and although it has evolved as a result of market changes and a shift in political leadership, its primary intent is still to increase credit availability by facilitating renewed issuance of consumer and business ABS at relatively normal interest rate spreads. Under TALF, the New York Fed provides non-recourse loans to qualified borrowers with eligible collateral, after approving loan applications made on certain days each month. The loans are made pursuant to a form Master Loan and Security Agreement, with the collateral held by a custodian as security for repayment.

The classes of eligible collateral have been rolled out in stages, with auto, credit card, equipment, and student loan securities included in the initial rounds. In May, the New York Fed announced that newly issued commercial mortgage-backed securities (CMBS) will be eligible for subscription in mid-June, and legacy CMBS (i.e., issued before January 1, 2009) will be eligible in July. As part of the expansion of TALF to CMBS, the New York Fed will offer not only the three-year terms initially set for TALF loans, but also five-year terms, which are more consistent with the longer terms of mortgages underlying CMBS. The New York Fed expects to make available up to $100 billion for such loans. The program may expand further later this summer with the addition of legacy residential mortgage-backed securities, although policymakers still are in the process of determining whether such an expansion would be feasible.

The extension of TALF to CMBS was well received by the real estate industry, which is hopeful that this increased liquidity will assist the refinancing of billions of dollars of commercial real estate loans. But the program still faces several obstacles to success.

The Federal Reserve has indicated that both new and legacy CMBS must have at least two triple-A ratings from five ratings firms (Standard & Poors, Moody's, Fitch, and now DBRS and Realpoint LLC), and cannot have a rating below triple-A from any of them. This requirement should not disrupt the issuance of new CMBS, but could materially limit the benefit for legacy CMBS, particularly since S&P has recently indicated that billions of dollars of highly rated legacy CMBS could be downgraded. According to Reuters on June 8, a Deutsche Bank analyst warns that the amount of legacy CMBS eligible for TALF loans could be reduced by half if S&P issues the downgrades.

In addition, opportunities for strong returns to investors are expected to diminish as money flows into securities bolstered by TALF, causing spreads to tighten. William C. Dudley, President of the New York Fed, admitted as much in a June 4 speech at a securities industry summit. “As investors begin to take advantage of the attractive TALF terms,” Dudley said, “spreads on ABS securities contracts and rates of return go down, and most importantly, the costs of funds for the issuers of the underlying securities falls.” Potential borrowers may also be wary of subjecting themselves to burdensome eligibility requirements. According to Dudley, TALF got off to a “slow start because investors were worried that the use of TARP funds in TALF could restrict their ability to conduct their business activities more broadly, perhaps in unanticipated ways and potentially retroactively.”

However, while TALF recipients are subject to inspections and audits of their financial records by the Federal Reserve, the loans are non-recourse, and the collateral will not be subject to re-margining requirements (i.e., adding to devalued collateral) or mark-to-market (i.e., fair value) accounting. Moreover, participation in TALF does not currently subject TALF sponsors, underwriters, and borrowers to the strict executive compensation rules that exist under TARP.

Recent reports indicate that the government is trying to minimize red tape and restrictions that could make TALF unattractive to issuers and investors. The Federal Reserve is also working to create vehicles to increase the participation of so-called “real money” investors (such as mutual funds, pension funds, and insurance companies) with cash on hand.

Investors should continue to monitor changes to TALF, as well as the PPIP Legacy Securities program, to identify new opportunities for favorable financing.

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