CLIENT ALERTS & INSIGHTS

Federal Reserve Announces 5-Year TALF Loans

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Current State of Affairs:

The economic stimulus package proposed by the U.S. Government includes a Term Asset Backed Securities Loan Facility ("TALF"). TALF is a joint program of the Federal Reserve Bank and the U.S. Treasury that makes non-recourse loans available to investors to buy certain asset-backed securities.

On May 1, 2009, the Federal Reserve Board announced that beginning in June, TALF will be extended to include loans with five-year maturity dates for the purchase of commercial mortgage backed securities ("CMBS"). Initially, TALF only supported one to three year, non-recourse, real estate loans.

Concern of the Real Estate Industry:

The basic concerns with this proposal are as follows: (1) Many commercial real estate mortgage loans are structured on a seven to ten year term basis. Therefore, the government's proposal to back five-year loans may fall short of supporting the industry's needs; (2) Investors may balk at purchasing CMBS through TALF for fear that the government will change the terms of the loan after the CMBS have been purchased. For example, the federal government loaned money to AIG and then changed the terms of the loan retroactively. Similarly, responding to public pressure, Congress approved a 90% retroactive tax on bonuses to AIG executives. This type of uncertainty may scare off many potential CMBS investors; (3) Even if TALF succeeds, and investors are willing to buy CMBS - clearing bank balance sheets of the debt accumulated since July 1, 2008 - who is to say that banks will continue to lend money to developers? In a market where, over the past year, there has been a dramatic shift in the nature of commercial real estate development, banks may choose to avoid commercial real estate loans altogether in favor of other types of loans.

Solutions:

Longer Term Loans.

While five years is an improvement over the previous three-year term loans proposed under TALF, it may fall short. Typically, seven to ten year loans are put in place on commercial real estate assets. To stabilize the commercial real estate industry, TALF should expand its loan scope beyond five years to allow investors to borrow money for a period of time mirroring the length of the CMBS loans.

The Need for Certainty.

Once the government puts the TALF program in place for CMBS, it should provide assurances to investors that loan terms will not change after the CMBS have been purchased. The purpose of TALF is to stimulate investor interest in CMBS and jumpstart the commercial real estate lending market. Retroactive changes to the CMBS terms may scare off future investors and damage the positive effect that TALF would otherwise have on the real estate industry.

Loan Standards.

As of May 6, 2009, no underwriting standards have been announced. While it is appropriate for the government to insist of stricter standards for commercial real estate lending, those standards must be realistic. For example, requiring 25% equity may work, but requiring 35% equity may not. If the government, and subsequently banks, don't have reasonable and realistic requirements for commercial real estate loan underwriting, then even though the underlying assets are sound, borrowers will continue to default on loans as they are unable to meet underwriting requirements that are unduly conservative.

Once Burned; Twice Shy.

There were a few banks that made a significant profit at the end of the first quarter of 2009. Despite the profits, those banks did not resume, on any significant scale, loaning money to developers in an effort to re-engage in the real estate finance game. Having suffered significant losses with prior real estate loans (even if it was, in many instances, the result of poor decision making) some lenders are likely not to re-enter the commercial real estate lending market on a significant basis - if at all. Faith of the banking world in real estate development must be restored for TALF to function as the government hopes it will.

In 2009, over $400 billion dollars of commercial real estate debt will come due. The stage is set for TALF to play a critical role in resuscitating the commercial real estate industry. We are hopeful that the change in term length to five years is but the first of a number of changes to the TALF program in an effort to revitalize the commercial real estate lending market.

Additional Information

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