

TALF: Introduction of Commercial Mortgage-Backed Securities (CMBS)

June 16, 2009

After four months of successful Term Asset-Backed Securities Loan Facility (TALF) auctions, the New York Fed is about to launch the second phase of the program, which will include CMBS. The first subscription date for CMBS will be on June 16th and only for new issue CMBS (2009 deals with underlying loans no older than July 1, 2008). Although we don't expect to see a new deal come to market this month for the auction, the opening of the program will facilitate the origination of new mortgages. Already over ten transactions have been submitted to the New York Fed requesting TALF approval. We expect the first of these deals to start hitting the market in the July auction. Going forward, CMBS subscription dates will fall in the middle of the month, as opposed to the ABS auctions which occur in the beginning of every month. Legacy CMBS (deals issued prior to 2009) are expected to become eligible starting in the July auction. Although most of the details with regards to the financing terms are available now, there are some questions yet to be addressed by the New York Fed regarding asset eligibility and the loan allocation and settlement process that investors need to know prior to participation. Below is a brief summary of the current CMBS TALF terms along with additional commentary. These terms apply to both the new issue and legacy CMBS programs. A complete and current listing of the terms and conditions for both programs can be found on the New York Fed's website; <http://www.newyorkfed.org/markets/talf.html>.

Eligible Assets

To be eligible for TALF financing, each CMBS must have a credit rating in the highest long-term investment-grade rating category from at least two TALF CMBS-Eligible Rating Agencies and be the most senior security in its respective transaction. In addition, the CMBS must not have been downgraded or placed on review or watch for downgrade from a TALF CMBS-Eligible Rating Agency. While this is fairly straightforward for new issue CMBS, recent comments from S&P have created some uncertainty regarding the legacy program. S&P has proposed a series of changes to its methodology of rating CMBS bonds, putting that proposal out for public comment. The review process has not been finalized. If implemented as proposed, their plans would result in the downgrade of a significant portion of recent vintage CMBS, including the most senior securities, leading to a large portion of current legacy CMBS no longer eligible for TALF. Market color and public comments from the New York Fed suggest that if S&P does in fact make aggressive downgrades, eligibility rules will be adjusted to allow at least some of these downgraded bonds to be eligible. It's important to note that the New York Fed, as lender, is analyzing each transaction and retains the right of rejection if a CMBS imposes undue credit risk to them, irrespective of rating. While MetWest is very cautious on the prospects for commercial real estate, in our opinion, the super senior bonds of many legacy CMBS transactions are very well protected and not at risk of principal impairment. Recent comments from the New York Fed and other market participants suggest they agree with our assessment that S&P's possible actions as a result of the new proposal are reactionary and without fundamental basis.

Loan Terms and Haircuts

A TALF loan secured by a CMBS will have a loan term of 3 or 5 years at the election of the borrower. A 3 year loan will set its rate on the auction date at a spread of 100 basis points over the 3 year Libor swap rate and a 5 year loan at a spread of 100 basis points over the 5 year Libor swap rate. The haircut for any CMBS with an average life of 5 years or less will be 15% and increase by 1% for each average life year above 5. There is a maximum average life allowance of 10 years, resulting in a haircut of 20%. For the legacy CMBS program, the haircut amount will be applied to each asset's "par" amount, not market value. For example, if an eligible CMBS is trading at \$75 and has an average life of 5.0 years, it will require a haircut of \$15, or 15% of par. Effectively this is a 20% haircut on the market value ($\$15 / \75) of the asset. As the market price of any TALF eligible CMBS declines, the effective haircut as a percentage of market value increases. This is meant to provide the New York Fed more cushion on riskier assets, using market pricing as the determining factor of that risk.

Another unique aspect to the legacy CMBS program that does not apply to new issue CMBS nor consumer ABS TALF borrowing is the capping of the annual net interest cash flow to the borrower. For a 3 year loan, the cap will be 30% per annum. For a 5 year loan, the cap will be 25% for the first 3 years, followed by 10% and 5% in years 4 and 5. Any net interest cash flow above these caps will be used to pay down the TALF loan, leading to a de-leveraging of the respective investment. Any remittance of principal on the asset will be used to pay down the TALF loan in proportion to the haircut.

Credit Risk and TALF Returns

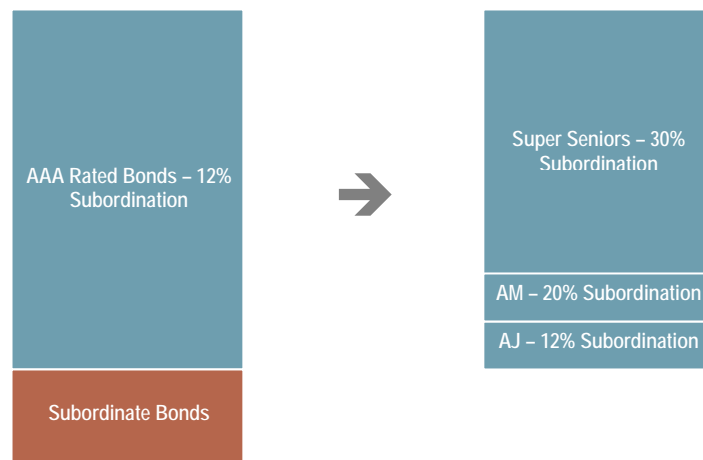
With most of the new issue and legacy CMBS TALF terms now clear, we believe that the inclusion of CMBS as a permitted asset class for TALF, after proper credit due diligence, offers the ability to improve a broader TALF portfolio. The inclusion of CMBS assets will offer both diversification and potential return benefits even after accounting for the legacy CMBS net

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interest cash flow caps and possible “tail” risk due to duration impact on the outstanding asset’s price. This “tail” risk can be hedged through a variety of liquid instruments that will increase in value should interest rates rise significantly and subject the fixed rate CMBS asset to price declines.

When discussing the inclusion of CMBS into a TALF strategy, we’re frequently asked about the credit risk on the underlying asset and the return profile of the investment. To best address the credit risk, we’ll focus on legacy CMBS, as new issue CMBS will benefit from the same structural subordination plus the added benefits of loan-to-value ratios using current property valuations and the requirement of using in-place property revenues when determining a loan’s debt-service coverage ratio.

The most common legacy CMBS eligible for TALF will be the 30% super senior A4 class of a conduit transaction. A typical conduit transaction is about \$2 billion in size and contains approximately 150 loans, with the top 10 loans comprising about 50% of the collateral value. Multifamily, Retail, and Office are the 3 largest property sectors, usually representing about 75% of a CMBS transaction. The capital structure issues over 20 different classes of bonds ranging from the super seniors with 30% subordination all the way down through the mezzanine and below-investment grade classes. Dating back to 2005, conduit CMBS issuances have included the concept of the 30% super senior class. The diagram below shows how a super senior class is created by taking the original AAA bond, which usually requires about 12% subordination, and slicing that bond into multiple AAA rated bonds with three different levels of seniority. In effect, the subordinate bonds protect the AJ class, the subordinate bonds plus the AJ class support the AM class and the subordinate bonds plus the AJ and AM class support the 30% super senior class.



Source: MetWest

At today’s average dollar price of \$75, super senior bonds could experience up to a 40% impairment on their face amount while still delivering a positive return to the buyer. However, once leveraging the investment through TALF and effectively taking the first loss position of this super senior bond, the proper analysis should focus on the amount of credit losses within the transaction that would put the super senior bond at any material risk of principal impairment. Unlike excess spread and reserve accounts in most consumer ABS transactions, CMBS conduit transactions do not offer any additional credit enhancement beyond subordination. That means a CMBS transaction would need to incur a deal lifetime loss of 30% to begin to impair the super senior classes. This level of credit enhancement needs to be evaluated against the strong headwinds facing the commercial real estate market.

Current CMBS market changes include:

- Commercial real estate prices down 20-25% from their peak compared to underwritten loan-to-value ratios of approximately 70%
- Declining property revenues, revenues falling short of pro-forma projections, and partial interest-only periods ending over the next few years on recent loan vintages, all weighing on original debt-service coverage ratios of approximately 1.5x
- Limited and restrictive financing options currently available to borrowers with loans coming due

While we are certainly in turbulent waters, to our knowledge no conduit CMBS vintage has ever experienced a cumulative lifetime loss of greater than 3% (1996), and in fact dating back to 1972, no vintage of fixed conduit loans has experienced losses greater than 7.8%. Yes, while we expect that commercial real estate defaults will continue to rise over the next year, fifteen months into the recession, the CMBS delinquency rate stands below 3%. Servicers continue to craft solutions and

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prevent foreclosure on troubled loans (5% of the conduit universe is in special servicing) and the introduction of TALF into the new issue CMBS market should open the financing window for maturing loans. Total loan defaults of 50%, with severity rates of at least 60%, all contributing to generate deal losses of 30% or more, even against the backdrop of the recession, appear extreme and suggest that the 30% subordination offers investors plenty of protection against future losses. In addition, every dollar of discount to par on a legacy CMBS super senior bond offers investors that much more protection against loss on investment. By no means are all deals created equal, and diligent credit work is necessary, but with the proper process in place, we feel that good investments eligible for the TALF program can be found within the CMBS sector.

Due to the non-recourse and non-marked-to-market aspect of the term funding for CMBS, most of the analysis of the return relies upon the asset's value upon the maturity of the loan. Key inputs to the annual cash yield such as haircut, asset coupon, and financing cost are fairly straightforward and set at the trade's inception. If a CMBS matures prior to the loan's final due date, the return analysis is a simple function of the annual cash yield plus the levered benefits gained from the difference between par and the discounted price at which the asset was purchased. For a CMBS still outstanding at the loan's final due date, we've put together the following analysis to help demonstrate the range of returns that are dependent upon the asset's sale price. This return analysis is for a legacy super senior CMBS with 30% credit enhancement. The CMBS currently trades at a price of \$74.25, has a 5.88% coupon, and an average life of 8.1 years.

<u>Asset Terms</u>		<u>Loan Terms</u>	
Current Face:	\$100,000,000	Loan Amount:	\$55,250,000
Price:	\$74.25	Haircut (19% on face):	\$19,000,000
Yield-to-Maturity	10.87%	Loan Term	5 years
Coupon:	5.88%	Loan Rate (5yr Swap Rate + 100bps):	4.41%

Projected Annual Cash Yields (excluding capped yields in years 4 & 5)

Asset Coupon:	\$ 5,880,000
Loan Interest Due:	- \$ 2,436,525
Net Cash Flow:	\$ 3,443,475

Net Cash Flow (\$3,443,475) / Haircut (\$19,000,000) = **Projected Annual Cash Yield (18.12%)**

Asset Sale Scenarios and Prices at the End of Year 5 and Resulting IRR's

<u>Complete Loss of</u>				
<u>Haircut</u>	<u>Purchase Price</u>	<u>Purchase Yield-to-Maturity</u>	<u>Purchase Spread-to-Swaps (700bps)</u>	<u>+350bps/Swaps</u>
\$25.00	\$74.25	\$87.63	\$91.13	\$100
-15.9%	19.6%	28.5%	30.5%	34.9%

Due to the unique combination of strong credit enhancement, non-recourse term financing, and the IRR scenarios above, we look forward to the introduction of CMBS into the TALF program and feel that its inclusion into a TALF only strategy will serve to further enhance the already compelling features of this unique program.

Projected results reflect a series of assumptions about the TALF program political, market and economic conditions. Such forecasts may not come to pass. MetWest reserves the right to change its outlook and forecasts without notice.

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TALF is a federal program which may be changed by the government with little or no notice. Current information on TALF can be found at: <http://www.newyorkfed.org/markets/talf.html>

Important Information Regarding MetWest

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