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The TALF Catalyst?

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In the latest "credit easing" move by the Federal Reserve Board ("FRB"), the FRB last week opened the door to stimulation of consumer spending by attempting to jump start the frozen securitization markets. On March 3, 2009, the FRB and U.S. Treasury Department ("Treasury") launched the first phase of the much anticipated Term Asset-Backed Securities Loan Facility (TALF), a program under the Fed's Consumer and Business Lending Initiative. The details regarding TALF have been highly anticipated since the Fed's initial announcement regarding TALF in November 2008. While terms and conditions have now been released for TALF's initial phase, questions remain regarding whether TALF will serve as the catalyst that the FRB and Treasury are looking for to thaw the consumer lending (and commercial) securitization markets.

The TALF Credit Facility

Similar to other recent FRB lending facilities, TALF is a FRB credit facility authorized under section 13(3) of the Federal Reserve Act. The program is currently backed by $20 billion in credit protection from Treasury, and is available to make up to $200 billion in loans to eligible borrowers maintaining specified eligible collateral. However, on February 10, 2009, Treasury and the FRB agreed to increase the size of the TALF dramatically – from $200 billion to as much as $1 trillion – as well as to expand the asset classes eligible to participate in the TALF.[1]

As currently structured, TALF will provide financing in the form of non recourse loans made by the Federal Reserve Bank of New York (FRBNY) to holders of certain asset-backed securities (ABS) as set forth in the terms of the program. TALF will occur in a series of monthly subscription and funding phases. The first phase, TALF 1.0, is focused on consumer and small business lending and will commence with an initial release of funds to eligible borrowers on March 25, 2009. A second TALF phase, TALF 2.0, will focus on the broader commercial lending markets (presumably utilizing Treasury's expanded funding of the program). And there is even discussion of a TALF 3.0 that would serve as the vehicle for the Administration's public/private partnership investment fund to deal with the bad assets currently weighing down banks' balance sheets.[2]

Under the "Current Terms and Conditions" of the FRBNY, TALF loans will have three-year terms, must have a face value of at least $10 million (but with no limit as to a maximum), are prepayable, and may be collateralized by a combination of eligible collateral.[3] TALF loans are not subject to mark-to-market or re-margining requirements.

TALF 1.0 – Consumer and Small Business Lending: Eligible Collateral and Borrowers

The first phase of TALF, or TALF 1.0, extends to borrowers who maintain certain ABS as collateral

for purposes of the TALF loans. "Eligible collateral" under TALF 1.0 includes U.S. dollar-denominated cash ABS (as opposed to synthetic ABS) having the highest long-term or short-term investment-grade ratings as obtained from at least two major nationally recognized statistical rating organizations (NRSROs), defined currently as Fitch Ratings, Moody's and Standard & Poor's. The credit exposures underlying the eligible ABS must be made up of at least a 95% exposure to U.S. domiciled obligors and must be in the form of (i) auto loans, (ii) student loans, (iii) credit card loans, or (iv) small business loans guaranteed by the Small Business Administration (SBA). The ABS must have been issued on or after January 1, 2009, and at least 85% of the credit exposures underlying the loans of the ABS must have certain origination or first disbursement dates, depending on the type of ABS.[4]

Under the current terms and conditions, an eligible borrower of TALF funding is any U.S. company owning the eligible collateral previously discussed and with an account relationship with a primary dealer. A "U.S. company" is deemed such if it is (i) a business entity organized under the laws of the U.S. or a subcomponent or territory thereof with significant operations in the U.S., including any U.S.-organized subsidiary; (ii) a U.S. branch or agency of a foreign bank (other than a central bank) maintaining reserves with the Federal Reserve; or (iii) a U.S. state or federally organized investment fund managed by an investment manager with a principal place of business in the U.S.[5]

TALF 2.0 – Commercial Lending: Prospects for Coverage

In a March 3, 2009, joint press release from the FRB and Treasury, the agencies discussed the roll-out of TALF 1.0, and also highlighted plans for expanding TALF's coverage to a much larger class of commercial assets and reiterated plans to increase the size of the TALF from $200 billion to as much as $1 trillion.[6] According to the press release, this phase of the program, TALF 2.0, is expected to expand TALF eligible asset classes to include newly issued AAA-rated commercial mortgage-backed securities (CMBS). In this regard, the agencies indicated they are working on ironing out the appropriate terms and conditions for accepting CMBS.[7] In addition, the agencies stated that a number of other types of AAA-rated newly issued ABS are being considered for the TALF 2.0 phase of the program.

Of particular note, the agencies highlighted that they anticipate ABS backed by rental, commercial, and government vehicle fleet leases, and ABS backed by small ticket equipment, heavy equipment, and agricultural equipment loans and leases will be eligible for the April funding of the TALF.

Finally, the joint press release indicated that other types of securities under consideration for TALF 2.0 include private-label residential mortgage-backed securities, collateralized loan and debt obligations, and certain other ABS not included in TALF 1.0, such as ABS backed by non-auto floorplan loans and ABS backed by mortgage-servicer advances. The FRB expected to announce the additional classes of ABS that are TALF eligible upon completion of the joint agency review, however, a timeframe for the analysis was not provided.

In discussing its plans for the TALF, the FRB noted that its focus is on "including securities that will have the greatest macroeconomic impact and that could most efficiently be added to the TALF at a low and manageable risk to the government."[8]

In a somewhat ominous note, the joint press release also included a discussion of the impact of the TALF and other FRB credit facilities on expanding the FRB's balance sheet. "In order for the [FRB] to conduct monetary policy over time in a way consistent with maximum sustainable employment and price stability, it must be able to manage its balance sheet, and in particular, to control the amount of reserves that the [FRB] provides to the banking system. The amount of

reserves is the key determinant of the interest rate that the Federal Reserve uses to pursue its monetary policy objectives."[9] It concludes with a statement that the agencies will pursue legislation to provide the FRB the tools it needs to manage reserves while supporting TALF and the FRB's other credit facilities.

Subscriptions and Funding

TALF loans are awarded to eligible borrowers based on a competitive bidding process. In order to bid, an eligible borrower must be a customer of a Primary Dealer. Only a Primary Dealer, acting as agent for the borrower, [10] can deliver eligible collateral to the NYFRB's custodian bank in order to complete a TALF loan transaction. While the TALF Master Loan and Security Agreement ("MLSA") establishes the terms by which a borrower can access the TALF, borrowers do not execute this document.[11] Rather, an eligible borrower must have executed a Customer Agreement authorizing the Primary Dealer, among other things, to execute the MLSA as agent for the borrower and to perform all actions required on their behalf.[12]

Prior to the TALF subscription dates, the first of which is March 17, 2009, the Primary Dealer must collect the following from an eligible borrower for submission to the custodial agent of the FRBNY:

- the amount of such borrower's loan request(s);
- whether the corresponding interest rate is fixed or floating; and
- the relevant CUSIPs and any offering documents of the ABS to be delivered and pledged to the FRBNY.

No less than two business days prior to loan settlement, the custodial agent of the FRBNY will send confirmation to the Primary Dealer providing the amount of the loan and the ABS that must be delivered to the FRBNY by settlement. The applicable administration fee and "haircut" amount will also be set forth in the confirmation for collection by the Primary Dealer and payment by settlement. Each TALF loan is subject to collateral haircuts depending on type, expected life and, in turn, the price volatility of each class of eligible collateral. Haircuts may change over the course of the program but an initial haircut schedule is set forth by the FRB in the Frequently Asked Questions section of the FRBNY's website dedicated to TALF.[13] The haircuts serve as credit protection based on the riskiness of the underlying collateral.

A requirement notable in its presence when the TALF terms and conditions were originally released and absent now, is the applicability of the executive compensation requirements of section 111 of the Emergency Economic Stabilization Act ("EESA"). As recently as March 3, the FRBNY website included a reference to the applicability of the EESA section 111 to ABS "sponsors." In effect, this would have imposed the panoply of executive compensation limitations now imposed on recipients under the Troubled Asset Relief Program ("TARP"). Notable in the FRB's decision to move away from EESA section 111 and the controversy regarding its applicability to the TARP, is a reference in the TALF-FAQs discussing the goal of the TALF to encourage securitizations to promote lending, including supporting ABS sponsors that provide credit and ABS investors that bring new capital to the frozen credit markets.[14]

The FAQ further provides that "executive compensation restrictions are targeted towards ensuring that executives of institutions that receive government support are not unjustly enriched at the taxpayers' expense. Given the goals of the TALF and the desire to encourage market participants to stimulate credit formation and utilize the facility, the restrictions will not be applied to TALF sponsors, underwriters, and borrowers as a result of their participation in the TALF."

Among the recent adjustments made to the TALF by the FRB, this may be one of the most

noteworthy in positioning the program to succeed. In addition to having the potential of keeping many borrowers away from the TALF, the EESA section 111 requirements held the possibility of imposing burdens that could have overwhelmed administration of the program. At a minimum, it was a significant factor that would have been heavily weighed by all potential borrowers.

On March 11, the FRB announced further changes to the form subscription agreements.[15] Noteworthy among the changes are those to the MLSA made to ensure that the program's loans are, in fact, non-recourse. In the earlier versions of the MLSA, when the collateral underlying a TALF loan was no longer deemed eligible, the investor would have to pay back the loan or find eligible collateral to replace it. Potential investors found this to be contrary to the intended non-recourse nature of the loans. The MLSA was revised to eliminate investor's concerns and ensure that the FRBNY can only claim collateral it initially holds, capping the borrower's potential losses related to the loan.[16] Another notable change relates to the audit rights of the FRBNY and its representatives. Originally the MLSA permitted extensive audit rights that allowed the FRBNY to look into potentially every aspect of the financial affairs of a borrower or primary dealer. The March 11 amendments to the MLSA limited these rights so that any financial audit relates solely to the TALF loans.[17]

Why TALF?

TALF, the latest iteration in the FRB's efforts to use its liquidity tool to ease the current economic crisis, continues the FRB's focus on the asset side of its balance sheet by extending credit and/or purchasing securities. The FRB is quick to differentiate this policy from that of quantitative easing that looks to the use of the whole balance sheet to generate an upturn in the economy (and which has had questionable results when utilized by central banks of other countries). TALF uses the FRB's asset-side focus to target the dislocated securitization markets.

Since October 2008, the issuance of consumer ABS has come to a virtual halt. In 2007 investors bought $1.6 trillion of ABS backed by mortgages or other types of loans; in 2008, that number fell to $313.9 billion; and in January of this year, banks issued just $1.6 billion of such ABS.[18] Interest rate spreads on AAA-rated consumer ABS currently face high risk premiums based on the locked credit market. Traditional investors have exited the market or have little appetite to increase ABS holdings until the market is more normalized, and nontraditional investors lack funding for investment in consumer ABS.[19] Although a decrease in demand for these investments naturally accompanies a recessionary period, the pressure on participants in the consumer ABS markets is particularly intense. Clearly, restoring the securitization markets has the potential to produce significant gains in the overall economic recovery strategy.

Does TALF Do Enough?

It is hard to predict the impact TALF will have on consumer lending and the securitization markets. This type of massive lending program is a novel concept that has not been tested. For now, the program is available only for loans against the highest-rated (AAA-rated) securities, which leaves out a large segment of junior bonds that continue to be difficult for banks to sell given investor fears. In a statement to Congress on March 5, 2009, U.S. Treasury Secretary Timothy Geithner indicated that the FRB is "open to suggestions" about how to expand TALF, given the concerns that the program does not go far enough to kick start consumer lending. According to Geithner, the FRB will "continue to look at ways to make that program work" including expansion to less than AAA-rated securities.[20] This is an important placeholder that may become critical in the months ahead if the credit markets continue to remain unresponsive.

Since the announcement and release of the TALF Current Terms and Conditions by the FRBNY, investors have begun announcing the possibility of participation in the program. However,

uncertainty remains regarding the underlying TALF process. In the current environment, some will perceive the TALF as subsidizing investors, such as hedge funds and private equity firms, who are able to obtain FRB loans to pursue significant annual returns.[21]

The biggest challenge for the FRB in implementing the TALF appears to be focusing on the extension of TALF to include securities that, while achieving a desirable macroeconomic effect, do not present unmanageable and unacceptable risk to the FRB – and the taxpayer. In this regard, expect to see the FRB and Treasury approach each monthly TALF subscription as a learning process to achieve the optimal balance of risk and reward in applying this credit-easing strategy.

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1 See Joint Statement on the Financial Stability Plan by Secretary of the Treasury Timothy F. Geithner, Chairman of the Board of Governors of the Federal Reserve System Ben S. Bernanke, Chairman of the Federal Deposit Insurance Corporation Sheila Bair, Comptroller of the Currency John C. Dugan, and Director Of The Office Of Thrift Supervision John M. Reich (February 10, 2009).

2 See Policy Uncertainty Fogs the Outlook, R. Berner and D. Greenlaw, Morgan Stanley Global Economic Forum (March 11, 2009).

3 See Federal Reserve Bank of New York, Term Asset-Backed Securities Loan Facility: Current Terms and Conditions (March 3, 2009) and Federal Reserve Bank of New York, Term Asset-Backed Securities Loan Facility: Frequently Asked Questions ("TALF-FAQs") (March 3, 2009) under "Operational Mechanics."

4 Only SBA Pool Certificates and Development Company Participation Certificates have earlier issuances dates (on or after January 1, 2008) regardless of the date of the underlying loans. See Federal Reserve Bank of New York, Term Asset-Backed Securities Loan Facility: Frequently Asked Questions, March 3, 2009 under "Eligible Collateral." Eighty-five percent of the loans: underlying auto loan ABS must have been originated on or after October 1, 2007; underlying student loan ABS must have had a first disbursement date on or after May 1, 2007; underlying small business ABS (SBA-guaranteed) must have been originated on or after January 1, 2008; and underlying credit card and auto-dealer floorplan ABS must have been issued to refinance existing ABS, maturing in 2009 and in amounts no greater than the amount of the maturing ABS.

5 Please see http://www.newyorkfed.org/markets/talf_faq.html for all of the frequently asked questions pertaining to TALF.

6 See joint press release, U.S. Treasury and Federal Reserve Board Announce Launch of Term Asset-Backed Securities Loan Facility (March 3, 2009).

7 In addition to achieving consistency and uniformity in documentation, a key issue appears to be the longer term horizon associated with CMBS. Under the existing terms and conditions for the TALF, TALF loans have three-year terms. This may be problematic for CMBS, while extending beyond three years may be viewed as undermining the FRB's efforts to establish a facility "designed in a way that gradually reduces its attractiveness and scale as the economy and financial conditions recover." See Joint Statement at note 2.

8 See Joint Statement at note 2.

9 See Joint Statement at note 2.

10 A list of FRBNY Primary Dealers is available at http://www.newyorkfed.org/markets/pridealers_current.html.

11 A copy of the MLSA is available at http://www.newyorkfed.org/markets/MLSA_031009.pdf.

12 The Customer Agreement establishes the terms of the agency relationship between the Primary Dealer and the borrower. Generally, the Primary Dealer agrees to carry out the terms of the MLSA on behalf of the borrower, while the borrower agrees to deliver the required loan collateral, and pay the necessary fees and costs, to the Primary Dealer to complete the TALF loan transaction.

13 See TALF-FAQs, under "Haircuts and Rates."

14 See TALF-FAQs, under "Other."

15 See http://www.newyorkfed.org/markets/talf_docs.html?date=03112009 which includes redlined changes of the base documents.

16 See "TALF Investors Wary of Collateral Damage", Peter Eavis, The Wall Street Journal, March 12, 2009.

17 See the March 11, 2009 revisions to the Covenants section (Section 11) of the MLSA, at http://www.newyorkfed.org/markets/talf_docs.html?date=03112009.

18 U.S. Tries a Trillion-Dollar Key for Locked Lending, Vikas Bajaj, The New York Times, February 20, 2008.

19 Federal Reserve Bank of New York, The Consumer and Business Lending Initiative (a White Paper), March 3, 2009.

20 "Geithner Says Administration Will Ensure Bank Access to Funding," Bloomberg.com, March 5, 2009.

21 This, among other things, notes MIT economics professor, Simon Johnson (in discussing TALF with the New York Times, February 20, 2008) leads to TALF raising "a lot of questions."