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Will TALF's New Terms and Conditions Stimulate Securitizations?

This past Friday, February 6, 2009, the Federal Reserve Board released the terms and conditions of the Term Asset-Backed Securities Loan Facility (TALF), which was first announced on November 25, 2008. Through the TALF, the Fed intends to increase credit availability for consumers and small businesses, generate liquidity for banks, stimulate an otherwise anemic asset-backed securities (ABS) market and reduce interest rate spreads on AAA-rated tranches to more normal levels. Another benefit of the TALF is that it will assist entities that have received TARP funds to meet political and regulatory pressures to demonstrate new lending even if they are struggling with liquidity concerns.

Under the TALF, up to $200 billion in three-year non-recourse loans will be made available to eligible ABS investors by the Federal Reserve Bank of New York. The NY Reserve Bank will take a security interest in the ABS and, if the borrower defaults, then the NY Reserve Bank will sell the collateral to a special purpose vehicle established for this purpose. Using TARP funds, the U.S. Treasury Department will purchase $20 billion of subordinated debt issued by the SPV.

Any U.S. company (including a U.S. branch of most foreign banks or a U.S. unit of an offshore fund) that owns eligible collateral and maintains an account with a primary dealer may borrow funds from the TALF. Eligible collateral includes ABS that are:

- issued on or after January 1, 2009;
- non-synthetic;
- U.S. dollar-denominated;
- cleared by The Depository Trust Company;
- rated in the highest long-term or short-term investment-grade category by two or more nationally recognized statistical rating organizations (NRSRO), although ratings are not required for eligible small business loans;
- not dependent on a third-party guarantee to achieve such a rating;
- not rated below the highest long-term or short-term investment-grade category by any NRSRO; and
- not placed on a watch list by any NRSRO.

Additionally, to be eligible, credit card ABS and dealer floorplan ABS must be issued to refinance ABS that are maturing in 2009 and must be issued in amounts no greater than that of the maturing ABS. Eligible auto loan ABS and credit card ABS must have an expected life of no greater than five years.

The assets underlying eligible ABS initially must be auto loans, student loans, credit card loans or small business loans, and cannot themselves be synthetic or non-synthetic ABS. Commercial mortgages, nonagency residential mortgages and other asset types may be included in the program later if that would further support credit markets. At least 95 percent of the obligors on the underlying loans, regardless of type, must be U.S.-domiciled. Additionally:

- at least 85 percent of underlying auto loans must have been originated on or after October 1, 2007;
- at least 85 percent of underlying student loans must have a first disbursement date on or after May 1, 2007; and
- all underlying small business loans must be backed as to principal and interest by the full faith and credit of the U.S. Small Business Administration and must have been originated on or after January 1, 2008.

The Fed should release publicly the TALF's commencement date later this month. Once operations have started, the NY Reserve Bank will announce monthly TALF loan subscription and settlement dates on which borrowers may request loans and indicate the amount of eligible collateral to be pledged. The program is designed to encourage investing, but is not available to securitization sponsors: a borrower may not pledge collateral that it or any of its affiliates originated or securitized.

Borrowers may choose between fixed- and floating-rate loans. The fixed interest rate is set at 100 bps over the three-year LIBOR swap rate; the floating interest rate is set at 100 bps over the one-month LIBOR. An administrative fee equal to 5 bps of the loan amount will be assessed by the NY Reserve Bank. The NY Reserve Bank will also apply haircuts, which in reality are loan-to-value ratios: how much the NY Reserve Bank will lend against the collateral pledged. Haircuts vary across asset classes and the expected lives of the pledged ABS. Preliminary haircuts have been released by the Fed and are available at http://www.newyorkfed.org/markets/talf_terms.html. TALF loans will not be subject to mark-to-market or re-margining requirements.

It remains to be seen whether the interest rates and haircuts set by the Fed are attractive enough to "lead to lower rates and greater availability of consumer and small business credit" as Ben Bernanke predicted in a speech he gave in January. However, prospective ABS issuers should consider preparing for the start of the TALF, to include these suggested action steps:

- evaluate the level of new originations based on the Fed's haircuts;
- stratify loan portfolios on an ongoing basis based on the respective loan origination dates prescribed by the TALF;
- prepare the required accounting certification;
- prepare the required ABS certification;
- prepare the required executive compensation certification; and
- add an ABS representation to prospectus and offering document templates.

Offshore organized hedge funds that desire access to TALF funds should consider creating a U.S.-organized entity to invest in eligible ABS, and interested investors lacking an account with a primary dealer should establish one. Additionally, all interested ABS investors should prepare by reviewing the TALF in detail to ensure compliance and by watching for the forthcoming master loan and security agreement from the NY Reserve Bank.

We plan to provide an analysis of the master loan and security agreement and a comprehensive TALF legal compliance agenda to our clients to help them work through the NY Reserve Bank's procedural and substantive requirements. Please feel free to contact us for copies.