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KIRKLAND ALERT

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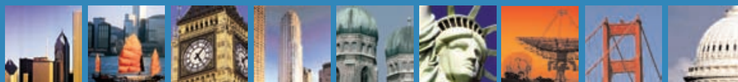

TALF 2.0: Will This Release Reboot The Market?

On December 19, 2008, the Federal Reserve Bank of New York released a revised set of terms and conditions for the Term Asset-Backed Securities Liquidity Facility, known inelegantly as the TALF. We refer here to the original terms as TALF 1.0 and to the new terms as TALF 2.0.

The Fed's goal for the TALF is to provide liquidity to the market for asset-backed securities (ABS) backed by pools of consumer assets in order to facilitate new issuances, and in turn revive consumer lending. The TALF 1.0 terms, released the day before Thanksgiving, provided little for which to be thankful. Poorly designed and seemingly conceived without market input, TALF 1.0 failed to elicit much interest from potential participants. To its credit, the Fed solicited market views, went back to the drawing board, and developed more promising terms. The Fed has broadened asset eligibility, clarified several ambiguities and significantly lengthened the maturity of TALF loans. But TALF 2.0 still has significant shortcomings.

The Fed hopes to make TALF 2.0 operational in February 2009. In our view, TALF 2.0 will not reboot the frozen market for consumer ABS. We believe further enhancements to the program will be needed to make it effective. We describe below the revised terms and improvements between TALF 1.0 and TALF 2.0, and then suggest the further features we think will be needed for a viable program.

Basics of TALF 2.0

Under TALF 2.0, the Federal Reserve Bank of New York (FRBNY) will make loans:

- to investors who are **eligible borrowers,**
- that are secured by **eligible collateral,** and
- that have a **transaction structure and pricing** specified by the FRBNY.

Eligible borrowers are entities formed under the laws of the United States, a state (U.S. entities) or U.S. branches or agencies of foreign banks. U.S. entities with foreign parents are acceptable, but the FRBNY is apparently not comfortable that it has authority to lend to U.S. based entities that have been formed offshore. An eligible borrower cannot be, or be an affiliate of, the originator or sponsor of the eligible collateral — the FRBNY is not setting up this program to provide direct funding to sponsors or their affiliates.

Eligible collateral means cash asset-backed securities (ABS) that have the highest investment grade rating from at least two major rating agencies, that have no lower ratings from other major agencies and that are backed by credit card receivables, student loans, auto loans — including auto leases and dealer floorplan loans — or SBA-guaranteed loans. All or substantially all of the underlying obligors must be U.S. domiciled. The ABS themselves must be issued on or after January 1, 2009, and — except for credit card ABS (CCABS) — all or substantially all of the underlying assets must have been originated fairly recently:

- Auto loans – on or after October 1, 2007
- Student loans – first disbursement on or after May 1, 2007
- SBA loans – on or after January 1, 2008
- CCABS – must be issued to refinance existing CCABS maturing in 2009, in amounts no greater than the maturing amounts

Even though the ABS must be rated AAA/Aaa or A-1/P-1, the FRBNY will reserve the right to reject or further scrutinize

"potentially high-risk ABS that a borrower proposes to pledge." Interestingly, the FRBNY says that the primary dealer through which an investor submits a loan request is expected to "pre-screen" the pledged ABS to determine that it is eligible collateral. Also, collateral substitution is not permitted.

The sponsor of the eligible collateral must also agree to subject itself to the executive compensation requirements of the Emergency Economic Stabilization Act of 2008.

The FRBNY leaves the door open to possible future expansion of TALF to cover other asset types, such as RMBS and CMBS.

The **transaction structure and pricing** for TALF loans includes the following key features:

Term. Each TALF loan will have a three-year maturity, with no penalty for prepayment.

Pricing. The borrower will pay an upfront fee for each loan. The borrower will have the choice of a fixed rate loan or a floating rate loan at rates to be established by the FRBNY.

Haircuts. The FRBNY will establish a "haircut," or advance rate, for each type of eligible collateral, based on its "riskiness" and the maturity of the eligible ABS. The FRBNY reserves the right to change both haircuts and interest rate spreads over time, "consistent with the policy objectives of the TALF."

Allocation. One day each month, eligible borrowers will be able to request one or more TALF loans, specifying the eligible collateral, the desired loan amount and whether the loan should be at a fixed or a floating rate. The minimum size of a loan is $10 million. Loan proceeds will be disbursed upon receipt of the collateral by the FRBNY's custodian.

Payment Terms. TALF loans will be non-recourse to the borrowers. All principal distributions on the eligible ABS must be paid through to the FRBNY to pay down the loans until paid in full. Interest on the loans will be due monthly.

TALF 2.0's Improvements

The TALF 2.0 release is a decided improvement on the original version. It provides more detail and eliminates some of the big problems of TALF 1.0. Among the key upgrades:

Loan Maturity. TALF 1.0 loans would have been just one year in maturity. A three-year maturity will be much better. Apparently, the FRBNY was originally concerned it did not have legal authority to make three-year loans.

Loan Allocation. TALF 1.0 contemplated competitive sealed bid auctions that would have provided a fixed amount of credit each month. TALF 2.0, on the other hand, is more open. The FRBNY will, it seems, indicate the available rates, and any borrower may apply for one or more TALF loans. The amount of credit available is not subject to a stated limit, although the overall program is presumably still limited to $200 billion outstanding.

Loan Paydowns. TALF 1.0 required that all principal *and interest* received on eligible collateral be used to pay down the associated TALF loan. That requirement would have absorbed all cash flow on the eligible collateral until the TALF loan was paid off. Under TALF 2.0, the investor will be able to retain the excess spread each month. However, principal payments on amortizing ABS will be required to be applied to pay down the TALF loan on a "turbo" basis, so an investor will not be entitled to retain any principal until the TALF loan is paid off.

Interest Rates. TALF 1.0 contemplated only floating rate loans at a spread over the overnight index swap rate (OIS). TALF 2.0, by contrast, permits both fixed and floating rate loans. That change will allow investors to buy fixed rate ABS without having either to bear or hedge the interest rate mismatch.

Eligible Collateral Specifications. TALF 1.0 said only that the underlying credit exposures had to be "recently originated." TALF 2.0 provides much greater specificity. The new release also recognizes that CCABS, because of the revolving nature of the underlying assets, cannot be held to an "origination date" standard. TALF 2.0 also expands the auto collateral to include auto leases and dealer floorplan loans, which will help the auto issuers.

But Questions Still Remain...

Although TALF 2.0 clarified the situation, many questions are still to be answered. Some are technical issues, while others go to the fundamental viability of the program. Here are those we find most interesting:

- The biggest question, certainly, is whether the availability of TALF loans will provide investors with adequate incentives to purchase ABS in 2009 securitizations at spreads to which sponsors are willing to agree. The FRBNY has said that it "will set the interest rates on TALF loans so as to provide borrowers with an incentive to purchase eligible ABS at yield spreads higher than in more normal market conditions but lower than in the highly illiquid conditions that have prevailed during the recent turmoil in the financial markets" but investors currently can purchase seasoned ABS in the secondary market at very wide spreads. So, it remains to be seen whether the absolute rate and spread levels at which sponsors will be willing to issue and investors will be willing to invest will be accommodated by the TALF lending rates established by the FRBNY.

- What will be the size of the borrowing base discount the FRBNY will apply to eligible collateral? As with interest rate and spread levels, the size of the haircuts on eligible collateral established by the FRBNY will also have a material impact on investor incentives. The greater the leverage available to investors, the more easily investors can obtain returns on the new ABS that match or exceed the return on unleveraged investments in secondary ABS.

- It is not clear that the FRBNY has resolved the "chicken and egg" problem that plagued TALF 1.0. The new release still seems to require that, on the one day a month that TALF will take applications, investors must own — or at least specifically identify — the exact ABS they intend to pledge. If investors must identify the exact ABS, then the ABS must either be previously issued or be in the middle of its marketing period. Investors cannot specifically identify securities that are not in existence or in their marketing period. But that raises the question of how far ABS issuers will proceed in structuring and marketing offerings in the absence of investors who already have TALF commitments in hand.

- How will the FRBNY assess "riskiness" of ABS that can be pledged? Will it be based on asset quality (e.g., subprime), sponsor financial condition, historic loss rates or some other types of considerations? Will it make those assessments known in advance, to avoid tripping up unsuspecting investors who buy a particular ABS, only to find out subsequently that it is on the disfavored list? Will the FRBNY publish criteria so that issuers and investors can develop a clear understanding of the parameters of TALF?

- Will the exclusion of offshore investors, like the offshore sister funds used by hedge fund complexes, significantly reduce the eligible pool of investors? Or will hedge funds and other investors find ways, like participation interests, to make this benefit indirectly available to offshore entities? Will banks with yet to be invested TARP funding find the TALF funding attractive enough to operate within the parameters of the TALF program?

- Will the FRBNY be willing to lend on a non-recourse basis against ABS that have rated final maturities beyond the three-year maturity of the TALF loans? There is nothing in TALF 2.0 that suggests that eligible collateral must have a final maturity within three years. It would seem, then, that an investor could pledge a ten-year CCABS as collateral. If so, will the FRBNY establish a higher haircut for longer term collateral? That would seem likely. Investors would then have the option at loan maturity of either paying the remaining balance or just walking away from the collateral.

- Will the FRBNY be successful at establishing haircuts that are both small enough to provide investors with the necessary incentives while at the same time large enough to effectively manage the risk that investors could walk away from their collateral in lieu of repaying their TALF loans in the face of significant market value declines?

- Will CCABS find the refinancing requirement to be problematic? How tightly will FRBNY define "refinancing?"

- Will the credit exposure origination date of October 1, 2007, be problematic for dealer floorplan loans? Securitizations of these assets, as with CCABS, are done through master trusts filled with revolving lines of credit. But the rapid turnover of inventory at dealers — though it has slowed dramatically in recent months — makes it likely that only a small percentage of floorplan receivables were originated more than 15 months ago.

- Will disclosure documents for 2009 ABS contain a statement as to whether the issuing entity considers the ABS to constitute eligible collateral for TALF? Only the originator will be able to certify to its compliance with the executive compensation

requirements of the Emergency Economic Stabilization Act of 2008. Given the complexity of the various executive compensation provisions and the general uncertainty as to the FRBNY's interpretation of a number of the TALF eligibility requirements, it would seem unlikely that the practice would develop of outside counsel opining as to TALF eligibility.

- There are also mechanical questions about the implementation of the TALF that will be important to its success or failure:
  - If an investor can obtain a TALF loan before it purchases eligible collateral (which is presently unclear), how long can an investor keep a TALF loan "commitment" open before it expires unused? Can an investor use some, but not all, of a TALF loan commitment?
  - How will the eligibility of ABS for the TALF be determined? Although primary dealers are supposed to pre-screen pledged ABS for eligibility, we imagine that the FRBNY will have the final word. Will issuers or investors know in advance that a given ABS issuance is eligible? What liability may primary dealers be assuming in the certification process?
  - Will investors know in advance what haircut the FRBNY will apply to a given ABS issuance? Will that haircut be the same for all ABS of a given asset class, or will it vary with maturity, expected prepayment speed or any other variable?
  - What types of floating rates will the FRBNY make available? TALF 1.0 specified OIS as the applicable index. What about LIBOR, Fed Funds or EDSF, all of which are used at times to price ABS?

Recommendation

TALF 2.0 is an improvement.But it seems to us that TALF 2.0 has flaws that would keep it from rebooting the frozen ABS market. We think that a TALF 3.0 release is needed. We understand that the FRBNY is continuing its conversations with market participants.

We think that a number of the questions we have raised above need to be answered. It should be relatively straightforward to answer most of them. But there are two key features that, individually or together, we think are critical to make TALF 3.0 a viable program:

- A mechanism that would allow eligible investors to obtain TALF loan commitments that will remain outstanding for, say, 10 to 30 days, which the investors could use to shop for new ABS. As part of this process, all or a substantial portion of the loan fees should be payable upon drawdown of the loans, rather than upon obtaining the commitment.
- A pre-offering review process through which the FRBNY will certify new consumer ABS as eligible collateral for TALF.

We recognize that the pre-offering review, in particular, would generate an unprecedented level of intervention by the FRBNY in the process of structuring ABS. But the alternative, which is the TALF 2.0 methodology, has the FRBNY performing the same analysis after the fact. And the fear of that after-the-fact rejection of a transaction will, we think, paralyze issuers and investors alike. Improved "transparency" is a mantra in the efforts to revitalize the securitization markets; the FRBNY needs to design a transparent program that will bring consumer ABS issuers and investors back together.

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