



TARP's Term Asset-Backed Securities Loan Facility: Can Wall Street Help Main Street?

On November 25, 2008, the Treasury and the Federal Reserve Board announced the creation of the Term Asset-Backed Securities Loan Facility, or TALF. The TALF was created to improve lending to consumers and small businesses by providing liquidity to securities backed by credit card debt, student loans, auto loans and small business loans guaranteed by the Small Business Administration. In announcing the program, the Treasury and the Federal Reserve Board noted that the \$240 billion annual asset-backed securities market that funds the consumer lending covered by the TALF had essentially come to a halt in October.

The TALF may, in the future, be extended for purchase of mortgage-related assets. In the interim, the Federal Reserve Board (Federal Reserve) also announced on November 25, 2008 that it will purchase direct debt obligations of Fannie Mae, Freddie Mac and the Federal Home Loan Banks as well as mortgage-backed securities guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae.

TALF is part of the Treasury's Troubled Assets Relief Program and is modeled after other programs launched by the Federal Reserve to facilitate resumption of more normalized extensions of credit and economic activity. Please see our coverage of these coordinated efforts and the current financial crisis at [Financial Crisis Legal Updates and News](#).

TALF Overview

The TALF is designed to increase origination of consumer and small business loans by providing liquidity to lenders. There has been a recent marked decrease in new auto loans, student loans and small business loans and a reduction in available credit lines and increased fees in credit card lending. Much of this constriction of consumer credit is attributed to the inability of the banks and finance companies that offer these loans to access the securitization markets for funding. TALF will fund the purchase of securities backed by these loans, with the hope that access to funding will increase lending activity.

The Federal Reserve has authorized the Federal Reserve Bank of New York (New York Fed) to make up to \$200 billion of non-recourse loans to eligible borrowers secured by eligible asset-backed securities (ABS). The Treasury will provide \$20 billion of credit support, as described below. By working with the Federal Reserve, the Treasury was able to announce a program aimed at alleviating some of the impact of the current crisis on consumers, without depleting TARP resources or presenting to Congress a plan for the final \$250 billion under the TARP.

Eligible Borrowers and Eligible ABS

An eligible borrower under the TALF is any U.S. person, including any citizen, business entity organized under the laws of the United States or political subdivision or territory thereof, including any entity with a non-U.S. parent, or a U.S. branch or agency of a foreign bank. Unlike many other programs established to address the current crisis, TALF is open to individuals, hedge funds and non-financial institutions. A borrower can not use a TALP loan to fund the purchase of ABS backed by loans originated by that borrower or its affiliate.

Eligible ABS must be backed by auto loans, student loans, credit card loans, or small business loans guaranteed by the Small Business Administration. These assets must have been originated by U.S.-domiciled originators that have agreed to comply with the TARP executive compensation requirements described below. The ABS must be U.S. dollar denominated and backed by assets generating cash flows; synthetic ABS are not eligible. At least two nationally recognized statistical rating organizations (NRSROs) must rate the ABS in their highest investment-grade ratings category, such as “AAA,” and no long-term rating from an NRSRO on the ABS may be below that level. This requirement could result in a significant creation of subordinated and lower-rated ABS that issuers may have to hold, given current market conditions.

The release indicates, without detail, that all or substantially all of the underlying loans must be newly or recently originated. This requirement addresses concerns that an ABS program would facilitate institutions selling existing “backlogs” of assets off their balance sheets without increasing lending to consumers. We expect more detail to be provided on the “all or substantially all” requirement.

Loan Structure

The New York Fed will make TALF loans to eligible borrowers on a non-recourse basis. The loans will be secured by a pledge of the borrower’s eligible ABS to the New York Fed. Cash flows from the ABS will be used to repay the loan. If there is a default on the loan, the New York Fed’s only recourse will be the ABS pledged as collateral. The TALF loans will have a one-year term, with interest payable monthly. Either the ABS will need to be structured with one-year maturities, or the borrower will need to repay the TALF loan and fund its ownership of the ABS at the expiration of one-year loan. Some borrowers may be willing to hold longer-term ABS, expecting that market values and liquidity will improve within the next year, but we expect many issuers will try to offer one-year ABS to utilize the TALF. For underlying assets with longer duration, such as car loans, issuers will need to hold the longer duration classes of ABS, or seek buyers in a difficult market.

Loan Pricing

Loans will be offered by the New York Fed through fixed amount, monthly, competitive auctions. Bids will be required to include a requested loan amount and interest rate spread over one-year overnight index swap, with the New York Fed setting a minimum bid for each auction. Collateral haircuts will be established for each asset class of eligible ABS, based on the applicable price volatility. A loan fee will be assessed by the New York Fed at the inception of each loan transaction.

Credit Protection from TARP

Treasury will be providing \$20 billion of TARP funds as credit protection for the TALP. The New York Fed will create a special purpose vehicle (SPV) to purchase and manage assets received in connection with TALF loans. The Treasury will purchase up to \$20 billion of subordinated debt issued by the SPV to fund the SPV’s purchase of ABS. Funds required by the SPV in excess of \$20 billion will be provided from the New York Fed, structured as a senior loan. Cash flows from the ABS held by the SPV will be used first to repay any amount outstanding on the senior loan and then the subordinate debt. Losses will be incurred first by the Treasury, up to its \$20 billion

investment, and by the New York Fed thereafter. Any excess income will be shared between the Treasury and the New York Fed.

Executive Compensation Requirements

Originators of the credit card receivables, auto loans and student loans, and sponsors of the student loan asset-backed securities, must be subject to or agree to be subject to the executive compensation requirements for direct purchases under the TARP. These are the same requirements agreed to by participants in the Treasury's Capital Purchase Program. As a result, many of the major financial institutions in the country have already agreed to these restrictions.

The executive compensation limitations apply to an originator's senior executive officers: the chief executive officer, chief financial officer and the three most highly compensated executive officers. The requirements include that:

- the compensation committee of the Board of Directors must certify that the compensation for senior executive officers excludes incentives to take unnecessary and excessive risks that threaten the value of the originator;
- the originator must have an ability to recover any bonus or incentive compensation paid to a senior executive officer that was based on statements of earnings, gains or other criteria that are later proven to be materially inaccurate;
- the originator is prohibited from making any golden parachute payment to a senior executive officer upon involuntary termination or upon the insolvency, receivership or bankruptcy of the originator;
- the originator's ability to take tax deductions related to the senior executive officers' compensation will be subject to a cap; and
- the originator and senior executive officers will be required to execute a waiver of any claims they might otherwise have a result of changes to compensation arrangements based on the TARP.

See our Client Alert "The Emergency Economic Stabilization Act's Effect on Employee Benefits and Executive Compensation" and related articles, available at [Financial Crisis Legal Updates and News](#).

Mortgage-Related Efforts

The Treasury and the Federal Reserve stated in their TALF announcement that the program may be expanded in the future to include other assets. These may include commercial mortgage-backed securities, non-agency residential mortgage-backed securities or other classes.

In addition, the Federal Reserve announced the initiation of a program purchase the direct obligations of Fannie Mae, Freddie Mac and the Federal Home Loan Banks (the GSEs) and a program to purchase mortgage-backed securities guaranteed by each of Fannie Mae, Freddie Mac and Ginnie Mae. The Federal Reserve noted that the costs of funding for these enterprises have recently increased appreciably. Purchases of these securities are designed to reduce their cost of funding, a savings which is expected to be passed on to home buyers in the form of increased access to credit and reduced cost.

The purchase of up to \$100 billion in GSE direct obligations will be conducted by the Federal Reserve's primary dealers through a competitive process. These purchases will start next week. The purchase of up to \$500 billion of mortgage-backed securities will be conducted by asset manager(s) selected via a competitive process. The Federal Reserve is seeking input from market participants on the structure of this program and will provide more detail at a later date. These purchases may start prior to year-end. Both programs are expected to extend well into 2009.

These Federal Reserve programs focused on mortgage-related efforts are independent of the Treasury's TARP and participants are not impacted by the TALF's executive compensation limitations.

Next Steps

We expect additional information to be provided by the New York Fed on the TALP as the program is structured, as well as an announcement of the first auction date. The Federal Reserve will provide more information on its purchase of mortgage-backed securities after it consults with industry participants to structure the program. And whether the Treasury and the Federal Reserve will extend TALP to mortgage-related assets may depend, in part, on Treasury's ability to access the additional \$250 billion under the TARP.

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