

# Financial Bulletin

Regulations and developments affecting the financial services industry May 2009

## What you need to know about TALF

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As the government has created programs to help spur economic recovery, a central question for firms has been: Is it worth it? While some institutions have benefited from the bailout's capital infusions, others have pushed to repay the money as soon as possible, citing too-stringent conditions. The latest program to enter the spotlight is the Term Asset-Backed Securities Loan Facility (TALF).

### What is the TALF?

The TALF was launched by the Federal Reserve in November 2008 to help jump-start consumer and small business lending by promoting the issuance of asset-backed securities (ABS). However, many firms have been reluctant to participate in the program, fearful of increased government scrutiny and restrictions such as the prohibition of hiring foreign workers. Investors are limited to receiving ratings from two of only three Nationally Recognized Statistical

Rating Organizations (NRSROs), and loan criteria exclude legacy or "toxic" assets. Firms also have been fearful of drawing ire for what could be perceived as earning profits at the expense of taxpayers.

Despite a slow start, \$10.6 billion of TALF loans were issued in May and the Fed estimates lending under the program could grow to as much as \$1 trillion. In addition, the TALF program is constantly under revision by way of an interactive process with ongoing feedback from potential investor groups so as to attract others, e.g., the addition of new asset classes. Starting in June 2009, eligible collateral will be expanded to include commercial mortgage-backed securities (CMBS) and insurance premium finance loans. According to the Fed, this move "will help prevent defaults on economically viable commercial properties, increase the capacity of current holders of maturing mortgages to make additional loans and facilitate the sale of distressed properties." In addition, the inclusion

of insurance premium ABS will help restore the flow of credit to small businesses.

### The benefits of investing in the TALF

Companies that invest in the TALF can leverage their money at attractive rates, resulting in better risk-adjusted returns. With a minimum loan size of \$10 million, the program is accessible for smaller private equity funds, hedge funds and private investors. In addition, TALF loans are non-recourse loans and are not subject to mark-to-market or re-margining requirements. Borrowers are not subject to the executive compensation limits that exist under the Troubled Asset Relief Program.

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## What you need to know about TALF (continued)

### Transaction structure, pricing and haircuts

TALF loans are non-recourse loans secured by eligible collateral, with a three-year term and interest payable monthly. TALF loans will not be subject to mark-to-market or re-margining requirements. Borrowers may pre-pay loans in whole or in part.

The table below summarizes the May 2009 loan request (and serves as an example of what future loan criteria may include), outlining loan terms, administrative fees, rates and haircuts. Each month the New York Fed publishes this information in advance of the cut-off date for applications:

Settlement Date:	May 12, 2009
Maturity Date:	May 14, 2012
Facility Open:	May 5, 2009 1:00 p.m. ET
Facility Close:	May 5, 2009 3:00 p.m. ET
Administrative Fee:	5.00 basis points
Eligible Collateral:	ABS1
Term:	3 years

**Rates will be set at 12:00 p.m. on May 5, 2009.**

Haircuts

Sector	Subsector	ABS Average Life (years)						
		0-1	>1-2	>2-3	>3-4	>4-5	>5-6	>6-7
Auto	Prime retail lease	10%	11%	12%	13%	14%		
Auto	Prime retail loan	6%	7%	8%	9%	10%		
Auto	Subprime retail loan	9%	10%	11%	12%	13%		
Auto	Motorcycle/other recreational vehicles	7%	8%	9%	10%	11%		
Auto	Commercial and government fleets	9%	10%	11%	12%	13%		
Auto	Rental fleets	12%	13%	14%	15%	16%		
Credit card	Prime	5%	5%	6%	7%	8%		
Credit card	Subprime	6%	7%	8%	9%	10%		
Equipment	Loans and leases	5%	6%	7%	8%	9%		
Floor plan	Auto	12%	13%	14%	15%	16%		
Floor plan	Non-auto	11%	12%	13%	14%	15%		
Servicing advances	Residential mortgage	12%	13%	14%	15%	16%		
Small business	SBA loans	5%	5%	5%	5%	5%	6%	6%
Student loan	Private	8%	9%	10%	11%	12%	13%	14%
Student loan	Gov't guaranteed	5%	5%	5%	5%	5%	6%	6%

For ABS benefitting from a substantial government guarantee with average lives beyond five years, haircuts will increase by one percentage point for every two additional years of average life beyond five years. For all other ABS with average lives beyond five years, haircuts will increase by one percentage point for each additional year of average life beyond five years.

Source: [http://www.newyorkfed.org/talf\\_operations\\_050509.html](http://www.newyorkfed.org/talf_operations_050509.html).

The Federal Reserve Board recently authorized TALF loans with five-year maturities versus the previous three-year term. TALF loans with five-year maturities will be available for the June funding to finance purchases of CMBS, ABS backed by student loans, and ABS backed by loans guaranteed by the Small Business Administration.

### The disadvantages of investing in the TALF

Eligible borrowers are subject to inspection (limited to only the TALF loans) by the Federal Reserve Bank of New York (New York Fed), which may include visits, audits and inspection of their financial records, etc. At the end of the term, investors will be required to refinance or hand the securities over to the New York Fed. In addition, TALF loans cannot be issued without approval of the New York Fed, and the window for receiving loans is narrow — no more loans will be issued after Dec. 31, 2009.

### How to apply for a TALF loan

The New York Fed recently published these guidelines<sup>1</sup> on applying for a TALF loan. To obtain a loan, the borrower must:

1. Be a U.S. company that owns eligible collateral and has an account relationship with a primary dealer. An entity is a "U.S. company" for the purposes of the TALF if it is:
  - a business entity or institution that is organized under the laws of the United States or a political subdivision or territory thereof (U.S.-organized) and conducts significant operations or activities in the United States (regardless of whether any such entity has a parent company that is not U.S.-organized), including any U.S.-organized subsidiary of such an entity;

<sup>1</sup> "How Investors Access the Term-Asset Backed Securities Loan Facility (TALF)," Federal Reserve Bank of New York, April 28, 2009. [http://www.newyorkfed.org/markets/talf\\_guide.html](http://www.newyorkfed.org/markets/talf_guide.html)

- a U.S. branch or agency of a foreign bank (other than a foreign central bank) that maintains reserves with a Federal Reserve Bank; or
- an investment fund that is U.S.-organized and managed by an investment manager that has its principal place of business in the United States. An “investment fund” is any type of pooled investment vehicle, including a hedge fund, a private equity fund and a mutual fund, or any vehicle that primarily or exclusively invests in eligible collateral and borrows from the TALF. An eligible investment fund includes funds that only invest in TALF-eligible ABS and only borrow from the TALF, as well as funds that invest in a mix of TALF-eligible ABS and other assets. Newly formed investment funds may borrow from the TALF as long as their collateral meets the collateral eligibility requirements.<sup>2</sup>

Conversely, any entity that is controlled by a foreign government or is managed by an investment manager controlled by a foreign government is excluded from borrowing from the TALF.

2. Have risk capital to invest. This capital, typically referred to as a “haircut,” represents the borrower’s economic stake in the transaction. Currently, the minimum loan size is \$10 million and the minimum haircut is five percent (or \$500,000).
3. Be interested in investing in consumer- and business-backed ABS asset classes, which are currently eligible for the program.

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## TALF investment example

ABC Hedge Fund (ABC) has a \$100 million TALF Opportunity Fund earmarked for investment in Auto – Prime Retail Loans. They are approached by Primary Dealer A who has a pool of five-year auto loans with a AAA investment grade rating amounting to \$15 million, and ABC decides to move forward and put in a loan request for the May 2009 TALF round.

Based on the table at left published by the New York Fed relating to the May subscription round, Auto – Prime Retail Loans (five-year loans) are subject to a 10% haircut. ABC would need to contribute \$1.5 million of its own funds and the New York Fed would provide funding for the balance of \$13.5 million. The interest rate is dependent on whether or not ABC decided to go with a fixed or floating rate. The loan would be for a period of three years.

Assuming after two years, the value of the securities rises to \$17 million. ABC decides to sell the loans. ABC will repay the TALF loan of \$13.5 million, recover its \$1.5 million investment and have a profit of \$2 million, which is a 133% return. However, if after three years, the loan value is \$12.0 million, ABC would hand over the loans to the New York Fed. Because the TALF loans generally are non-recourse to borrowers, ABC can simply hand over the securities, retire the \$13.5 million loan and lose their initial \$1.5 million investment, without additional penalty or risk.

Please note: This example excludes the impact of the interest ABC would earn, the interest paid on the TALF loans, administrative fees paid to New York Fed or features of asset-based securities such as amortization.

### Rates

Sector	Subsector	Fixed (Weighted average life in years)			Floating
		<1	1-<2	>=2	
Auto		1-year LIBOR swap rate + 100 bps	2-year LIBOR swap rate + 100 bps	3-year LIBOR swap rate + 100 bps	1-month LIBOR + 100 bps
Credit card		1-year LIBOR swap rate + 100 bps	2-year LIBOR swap rate + 100 bps	3-year LIBOR swap rate + 100 bps	1-month LIBOR + 100 bps
Equipment		1-year LIBOR swap rate + 100 bps	2-year LIBOR swap rate + 100 bps	3-year LIBOR swap rate + 100 bps	1-month LIBOR + 100 bps
Floor plan		1-year LIBOR swap rate + 100 bps	2-year LIBOR swap rate + 100 bps	3-year LIBOR swap rate + 100 bps	1-month LIBOR + 100 bps
Servicing advances	Residential mortgages	1-year LIBOR swap rate + 100 bps	2-year LIBOR swap rate + 100 bps	3-year LIBOR swap rate + 100 bps	1-month LIBOR + 100 bps
Small business	SBA loans 7(a)	N/A	N/A	N/A	Fed Funds Target + 75 bps
Small business	SBA loans 504	N/A	N/A	3-year LIBOR swap rate + 50 bps	N/A
Student loan	Private	N/A	N/A	N/A	1-month LIBOR + 100 bps
Student loan	Gov't guaranteed	N/A	N/A	N/A	1-month LIBOR + 50 bps

<sup>2</sup> “Term Asset-Backed Securities Loan Facility: Terms and Conditions,” Federal Reserve Bank of New York, April 3, 2009. [http://www.newyorkfed.org/markets/talf\\_Terms\\_090403.html](http://www.newyorkfed.org/markets/talf_Terms_090403.html)

## What you need to know about TALF (continued)

- Establish an account relationship with one of the program's agents, currently, the "primary dealers" that serve as the New York Fed's trading counterparties in the execution of U.S. monetary policy.
- Provide the primary dealer with information relevant to their "Know Your Customer" (KYC) program and due diligence procedures, or other additional information required to act as agent. This includes tax documents relevant to the principal and interest disbursements or background materials for credit assessments.
- Execute a customer agreement with the primary dealer. This agreement establishes the terms by which the dealer will act as the borrower's agent in the TALF program, based on basic guidelines provided in the New York Fed's Master Loan and Security Agreement.
- Acquire the ABS collateral (either by receiving an allocation of a new issue or buying the security in the secondary market) and arrange to deliver it to the New York Fed's custodian for the TALF program.
- Notify the primary dealer of the details of the loan request, including the amount, rate type (fixed- or floating-rate), and identifying information about the collateral (such as the CUSIP) prior to the monthly TALF subscription window.
- Provide the primary leader with the applicable haircut/margin and administrative fee (assessed by the New York Fed to cover its expenses) prior to the loan's closing date.
- Maintain a relationship with the primary dealer so they may provide the borrower with routine principal and interest payments until the loan matures, make repayments

or prepayments, or surrender the borrower's rights to the collateral in lieu of repayment. Each of these responsibilities is executed at the direction and on behalf of the borrower.

### What collateral is eligible?

TALF loans may only be secured by ABS that are:

- U.S. dollar-denominated cash (not synthetic) ABS with a credit rating in the highest long-term or short-term category from two or more NRSROs and which do not have a credit rating below the highest investment-grade rating from a major NRSRO. **ABS backed by SBA loans do not require an explicit credit rating;**
- not reliant on third-party guarantees for ratings and that have not been placed on review or watch for downgrade by any TALF NRSRO; and
- cleared through the Depository Trust Company.

In addition, ABS must be backed by student loans, auto loans, credit card loans, equipment loans, floor plan loans, small business loans (guaranteed by the U.S. Small Business Administration) and residential servicing advance receivables.

In most instances, the issue dates for eligible loans is Jan. 1, 2009 and after, and the average life of the loan must be no more than five years.

In a white paper<sup>3</sup> released on March 3, the Treasury Department and Federal Reserve indicated that TALF eventually may include ABS backed by non-agency residential mortgage loans, collateralized loan and debt obligations and other floor plan and dealer inventory loans.

A certified public accounting firm (e.g., one that is registered with the Public Company Accounting Oversight Board) must attest that the ABS is TALF-eligible. SBA Pool Certificates and Development Company Participation Certificates need not be accompanied by an auditor attestation.

### Is TALF in your future?

In the coming months, it is expected that participation in the TALF will grow as the government widens loan criteria, especially with the inclusion of CMBS in June. Financial services firms who partake stand to benefit from relatively inexpensive financing, as well as contribute to the economy's recovery. However, there are concerns that if investors are seen as profiting too much from the program, the government could change the terms of the program retroactively. In addition, participants will need the help of a professional services firm to navigate the complex application, structuring and attestation processes. Compliance will be an ongoing responsibility and challenge as the TALF continues to evolve – financial services firms and their advisers must decide if the opportunity is worth it. •

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<sup>3</sup>"The Consumer and Business Lending Initiative: A Note on Efforts to Address Securitization Markets and Increase Lending," United States Treasury Department and Federal Reserve, March 3, 2009. [http://www.ustreas.gov/press/releases/reports/talf\\_white\\_paper.pdf](http://www.ustreas.gov/press/releases/reports/talf_white_paper.pdf)