Federal Reserve and Treasury Announce Term Asset-Backed Securities Loan Facility

December 15, 2008

On November 25, 2008, the Federal Reserve Board ("FRB") and U.S. Department of the Treasury ("Treasury") announced the creation of the Term Asset-Backed Securities Loan Facility ("TALF"). The recent cooling of the securitization market has resulted in fewer sales of securities backed by auto loans, student loans, credit card loans and small business loans ("asset-backed securities" or "ABS"). This cooling, in turn, has resulted in the tightening of lending to consumers and small businesses. The TALF is designed to help these borrowers obtain loans by offering liquidity to lenders who hold asset-backed securities.

TALF Overview

Under the TALF, the Federal Reserve Bank of New York ("FRBNY") will lend up to $200 billion to eligible borrowers, who must pledge eligible ABS as collateral. The FRBNY, in turn, will create a Special Purpose Vehicle ("SPV") to purchase and manage the assets the FRBNY receives as collateral. Finally, through the Troubled Assets Relief Program ("TARP"), Treasury will purchase from the SPV $20 billion in subordinated debt to finance asset purchases. If the SPV purchases more than $20 billion in assets, the FRBNY will lend additional funds to the SPV through a loan that is senior to the TARP loan. Unless the FRB extends the period, the FRBNY is authorized to make new loans through December 31, 2009.

Eligible Borrower

An eligible borrower of TALF funds is any:

- U.S. citizen;
- Business entity organized under the laws of the United States or a political subdivision thereof, including an entity that has a non-U.S. parent; or,
- U.S. branch or agency of a foreign bank.

Eligible Collateral

To receive TALF funds, an eligible borrower must pledge ABS as collateral. To be eligible, the ABS must be:

- U.S. dollar-denominated cash (non-synthetic) ABS that have long-term credit ratings in the highest investment-grade category;
- Backed by credit exposures "all or substantially all" of which are "newly or recently originated" exposures to U.S.-domiciled obligors;
- Backed by auto loans, student loans, credit card loans, or small business loans guaranteed by the U.S. Small Business Administration;
- Backed by loans that are not themselves cash or synthetic ABS; and
- Backed by loans that were not originated by the particular borrower or an affiliate of the borrower.

The FRB may later expand the list of eligible ABS to include commercial and residential mortgage-back securities, as well as other asset classes.

Loan Terms

TALF loans will be non-recourse loans secured entirely by the pledged eligible collateral. The initial loan term will be one year; however, the FRB may extend the term at its discretion. Interest will be payable monthly. TALF loans will not be subject to mark-to-market or re-margining requirements.

The amount of a loan under the TALF program will be equal to the value of the pledged eligible collateral minus a haircut. For each class of eligible collateral, the FRBNY will establish a haircut percentage based on that class's price volatility.

Loan Pricing and Fees

The FRBNY will offer a fixed amount of TALF loans to borrowers through a competitive, sealed-bid auction process each month. Bids must include the desired loan amount and an interest rate spread over the one-year overnight index swap, with the FRBNY setting the minimum spreads for each auction. Additionally, due to the non-recourse nature of the loans, the FRBNY will assess a fee at the inception of each loan transaction.

Executive Compensation Requirements

Originators of the auto, student, credit card, or small business loans that underlie pledged ABS must comply with the executive compensation standards that Treasury requires of participants in the Capital Purchase Program ("CPP"). Generally, these standards:

- Limit compensation that contains incentives for senior executive officers (the principal executive officer, principal financial officer, or any of the three other mostly highly compensated executive officers) to take unnecessary and excessive risks;
- Require the "clawback" of certain compensation paid to a senior executive officer that was paid based on financial information that is later proven to be materially inaccurate;
- Prohibit any golden parachute payment to a senior executive officer; and
- Require the participant to agree to limit claims for federal income tax deductions for certain executive compensation.

For further information on the CPP's executive compensation requirements, see our prior Alert: U.S. Implements Four Programs under Emergency Economic Stabilization Act to Strengthen Market Stability.

Conclusion

Although the FRB has provided some detail about the TALF, some terms remain undefined and some questions unanswered. For instance, what constitutes "substantially all" of an asset-backed security's exposures? How much time must pass before a loan no longer qualifies as a "newly or recently originated" exposure?

Duane Morris will continue to monitor and comment on the regulations, guidance and interpretations concerning the TALF program and the Emergency Economic Stabilization Act ("EESA") as they become available.

For Further Information

If you have any questions regarding the TALF, TARP, or EESA, including how they may affect your company or its executives, please contact any member of the Corporate Practice Group, any member of the Business Reorganization and Financial Restructuring Practice Group or the attorney in the firm with whom you are most regularly in contact.