MORRISON | FOERSTER

News Bulletin

February 10, 2009

TALF to Launch with Updated Terms: Can Wall Street Help Main Street?

On February 6, 2009, the Federal Reserve Board (Federal Reserve) announced updated terms and conditions for the Term Asset-Backed Securities Loan Facility, or TALF, a joint program with the U.S. Treasury Department (Treasury). Updated terms clarify the pricing of TALF loans and refine eligibility requirements for borrowers and the asset-backed securities (ABS) pledged as collateral for TALF loans, including new restrictions on sponsors of eligible ABS.

On February 10, 2009, in coordination with the release of the Treasury's plan for next phase of the Troubled Assets Relief Program (TARP), the Federal Reserve announced its willingness to increase its TALF commitment from $200 billion to as much as $1 trillion. Treasury also announced expanding the program beyond the asset classes originally designated (credit cards, auto receivables, student loans and small business loans) to include commercial mortgage-related ABS and the Federal Reserve announced consideration of further expansion to include private label residential mortgage-related ABS and assets collateralized by corporate debt. Any expansion of the program would include an increased commitment from the Treasury from its current $20 billion allocation of TARP funds to $100 billion.

The TALF was created to improve lending to consumers and small businesses by providing liquidity to securities backed by consumer and small business loans. Initially announced on November 25, 2008, the first subscription date for TALF loans is expected this month, with a settlement date two weeks thereafter. As discussed below, the final terms, forms and subscription and settlement dates will be published by the Federal Reserve Bank of New York (New York Fed) at www.newyorkfed.org/markets/talf.html. TALF is part of the Treasury's TARP 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

In the third quarter of 2008, securitization funding for consumer and small business loans became unavailable. The TALF is designed to resume normalized originations of consumer and small business loans by providing low-risk funding for ABS investors, restarting the securitization markets for these products. The Federal Reserve has authorized the New York Fed to make up to $200 billion of non-recourse loans to eligible borrowers secured by eligible ABS (subject to an increase to up to $1 trillion as described above). The ABS will be pledged as collateral for the loans, and held at the New York Fed's custodian. If a borrower fails to repay its loan, the ABS will be transferred to a special purpose vehicle (SPV) to be established by the New York Fed. Treasury will purchase up to $20 billion in subordinated debt issued by the SPV; the subordinated debt will absorb the first $20 billion of losses at the SPV. The subordinated debt purchased by the Treasury would increase in proportion to the aggregate loans made by the New York Fed, up to a maximum of $100 billion. Any residual income from the SPV will be shared by the New York Fed and Treasury, after repayment of each of their loans.

Eligibility

The TALF has eligibility requirements for borrowers, for the ABS pledged as collateral for the loans, for the assets underlying the ABS and for the sponsors of the ABS. Primary dealers will also have program specific roles and responsibilities, which will be specified in detail in the master loan and security agreement to be entered into between the primary dealer, on behalf of its borrower clients, and New York Fed. The form of master loan and security agreement is expected to be published shortly on the New York Fed TALF website.

Borrower Eligibility

An eligible borrower must be:

- One of the following U.S. entities:
  - A business entity or borrower organized under the laws of the United States, or any of its political subdivisions or territories, that conducts significant operations or activities in the United States, including any of its U.S. organized subsidiaries;
  - 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, including any pooled investment vehicle such as a hedge fund, private equity fund, mutual fund or any vehicle that invests primarily in eligible collateral and borrows from the TALF, that is organized under the laws of the United States or any of its political subdivisions or territories, that is managed by an investment manager that has its principal place of business in the United States. The investment fund may be formed to participate in the TALF;

    Any of these may include a U.S. subsidiary of a foreign entity, provided the U.S. entity conducts significant operations or activities in the United States and the subsidiary (and, in the case of an investment fund that is a subsidiary of a non-U.S. entity, that fund's investment manager) is not controlled directly or indirectly by a foreign government. A foreign government "controls" an entity if it can vote 25 percent or more of a class of voting securities of the entity.
- An entity not affiliated with the sponsor of the ABS or the entity that originated the underlying assets; and
- A customer of a primary dealer that has authorized the primary dealer to execute the TALF master loan agreement on the borrower's behalf.

ABS Eligibility

To be eligible, ABS must be backed by eligible underlying assets, described below, and must be:

- U.S. dollar-denominated;
- Cash ABS (not synthetic);
- Rated in the highest long-term or short-term ratings category by at least two NRSROs, and not have a credit rating below that category from a major NRSRO; the rating can't be based on an insurance policy and in place of a rating, the small business backed ABS may be guaranteed by the full faith and credit of the U.S. government;[1]
- Cleared through the Depository Trust Company;

[1] ABS backed by loans, debentures or pools under the SBA's 7(a) and 504 programs will be eligible without an independent credit rating provided all of the underlying assets, or the ABS themselves, are fully guaranteed as to principal and interest by the full faith and credit of the U.S. government.

- Issued on or after January 1, 2009, other than SBA Pool Certificates or Development Company Participation Certifications which must be issued on or after January 1, 2008; and
- If backed by credit cards or auto dealer floorplan loans, issued to refinance existing similarly-backed ABS maturing in 2009 (such refinancing may be done up to three months prior to maturity, or for any prior maturity in 2009) and the aggregate TALF-pledged ABS may not exceed aggregate ABS maturing in 2009.

Eligible ABS may be issued on the settlement date for a TALF loan.

ABS Underlying Asset Eligibility

TALF-eligible ABS must:

- Be backed by auto loans or leases (auto includes cards, light trucks, motorcycles and recreational vehicles),[2] dealer floorplan receivables, student loans that are either government-guaranteed or private, credit card loans or small business loans guaranteed by the Small Business Administration;[3]
- Have at least 95% of the underlying assets, by dollar amount, from U.S. domiciled obligors; and
- Have at least 85% of the underlying assets, by dollar amount, meeting the following origination criteria:
  - Auto loan and auto leases must have been originated on or after October 1, 2007;
  - Student loans must have had a first disbursement date on or after May 1, 2007; and
  - SBA loans (other than those backing SBA Pool Certificates or Development Company Participation Certificates) must have been originated on or after January 1, 2008.

Expansion of the eligible asset classes is under consideration by the Federal Reserve. Additional asset classes under consideration include newly issued commercial mortgage-backed securities and private-label residential mortgage-backed securities.

Sponsor Eligibility

The TALF imposes requirements on the sponsors of eligible ABS, utilizing the SEC's Regulation AB definition for sponsor: an entity organizing and initiating an ABS transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.

The sponsor must certify in the offering document for the ABS that:

- The ABS is TALF eligible;
- A nationally recognized certified public accounting firm registered with the Public Company Accounting Oversight Board and retained by the sponsor has certified,[4] or will certify on the issuance date, that the ABS is TALF eligible;
- The sponsor will comply with the executive compensation requirements of the TALF;
- The issuer and the sponsor have executed an undertaking to the New York Fed indemnifying it from any losses it may suffer if the TALF certifications are untrue; and

[2] Commercial, governmental and rental fleet leases of cards, trucks and light trucks will not be eligible.

[3] Small Business Administration loans include loans, debentures, or pools originated under the Small Business Administration's 7(a) and 504 programs, provided they are fully guaranteed as to principal and interest by the full faith and credit of the U.S. government and meet the other TALF eligibility requirements.

[4] An example of an acceptable form of accounting firm certification can be obtained from the New York Fed by e-mailing the New York Fed Compliance Function at talf.compliance@ny.frb.org.

- With respect to credit card and auto dealer floorplan backed ABS, that the aggregate issuance pledged as collateral under the TALF does not exceed expected 2009 maturities.

The New York Fed has not released the method for providing the undertaking and indemnification regarding losses under the TALF.

The extensive participation of ABS sponsors in the process for acquiring a TALF loan will require borrowers and sponsors work closely together to issue TALF-eligible loans. In addition, sponsors of credit card and dealer floorplan ABS will be required to monitor the ABS pledged as collateral. Although the New York Fed's FAQs indicate that previously issued ABS may be pledged, a prospective borrower would need to work closely with the sponsor to amend or otherwise supplement the offering document in a manner acceptable by the New York Fed to satisfy these sponsor certification requirements.

Loan Structure, Fees and Pricing

Loans will be available on a monthly basis to eligible borrowers.

Loan Structure

The New York Fed will make TALF loans to eligible borrowers on a non-recourse basis. The loans will be secured by delivery to the New York Fed custodian of the borrower's eligible ABS. Principal cash flows from the ABS must be used to repay the proportionate principal amount of the loan; a loan with an advance rate of 90% will require 90% of principal cash flows be used to pay down principal of the loan. If there is a default on the loan, the New York Fed's only recourse will be to take possession of the ABS from the custodian. Upon any such default, the ABS will be transferred to the SPV.

TALF loans will have a three-year maturity, with interest payable monthly. Loans may be prepaid at any time, in whole or in part, subject to ABS minimum denomination requirements, without penalty. Loans may be transferred with the consent of the New York Fed.

Interest will be either fixed or floating, at the election of the borrower. Each month a borrower may subscribe for one fixed rate loan and one floating rate loan. The minimum loan size is $10 million dollars, and there is no maximum subscription size. Two days prior to the settlement date, the New York Fed custodian will confirm allocations to borrowers.

Loan Pricing

Loans will be available to borrowers on a monthly basis, with subscription and settlement dates to be announced on the New York Fed's TALF website. Although the first settlement date will be two weeks after the initial subscription date, the New York Fed may adjust dates in the future. Haircuts and interest rates described below are also subject to period review and changes, to be published on the TALF website.

Interest Rates: Interest on the TALF loans will accrue at a rate of 1-Month LIBOR plus 100 bps for floating rate loans, and 3-yr LIBOR swap rate plus 100 bps for fixed rate loans. The interest rate will be set two days prior to settlement date, and will be provided when the custodian confirms allocations to borrowers. Interest payments will be satisfied initially from ABS cash flows and borrowers will have a 30-day grace period for the payment of any unpaid interest.

Haircuts: Each loan amount will be subject to a haircut based on the credit characteristics of the underlying assets. Although subject to periodic review by the New York Fed, haircuts are expected to be initially as set forth in the following chart. For ABS with expected lives beyond seven years, haircuts will increase by one percentage point for each additional year of expected life.

		ABS Expected Life (years)						
Sector	**Subsector**	**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	6%	7%	8%	9%	10%		
Auto	Subprime retail	9%	10%	11%	12%	13%		
Auto	Floorplan	12%	13%	14%	15%	16%		
Auto	RV/ motorcycle	7%	8%	9%	10%	11%		
Bank Card	Prime	5%	5%	6%	7%	8%		
Bank Card	Subprime	6%	7%	8%	9%	10%		
Retail Card	Prime	6%	7%	8%	9%	10%		
Retail Card	Subprime	7%	8%	9%	10%	11%		
Student Loan	Private	8%	9%	10%	11%	12%	13%	14%
Student Loan	Gov't Gttee	5%	5%	5%	6%	7%	8%	9%
Small Business	SBA Loans	5%	5%	5%	5%	6%	7%	8%

Administrative Fee: An administrative fee of 5 bps will be assessed on the settlement date for all subscriptions that have been confirmed by the New York Fed's custodian two business days prior to settlement. If a borrower subscribes for a TALF loan, but fails to deliver the collateral to the custodian on settlement date, the borrower will be assessed the 5 bps administrative fee.

Executive Compensation Requirements

Sponsors of ABS collateralizing TALF loans will be required to comply with the executive compensation requirements established under Section 111(b) of the Emergency Economic Stabilization Act. In 2008, Treasury issued initial executive compensation rules under Section 111(b), and updated these with an interim final rule in January 2009. Those rules would apply to TALF sponsors, and are outlined below.

In addition, in February 2009, Treasury issued an outline of proposed amendments to the executive compensation requirements for participants in new programs, but specifically excluded existing programs such as the TALF. However, versions of the American Recovery and Reinvestment Act, or stimulus bill, have included executive compensation rules that would apply retroactively to beneficiaries of crisis related federal funding, such as TALF sponsors. Although many originators of consumer and small business assets may already be subject to executive compensation requirements through participation in the Treasury's Capital Purchase Program, those requirements terminate upon repurchase of the securities currently held by Treasury. Participation in TALF could potentially extend the executive compensation compliance period for sponsors. Prospective sponsors not currently subject to crisis-related executive compensation rules will need to consider carefully the limitations and compliance burden associated with the TALF. The executive compensation restrictions apply only to the ABS sponsor, and not to the borrowers under the TALF.

Based on the current rules, the executive compensation limitations apply to the senior executive officers of a company: the chief executive officer, chief financial officer and the three most highly compensated executive officers. The requirements include:

- The compensation committee of the Board of Directors must, within 90 days, review the compensation arrangements for the senior executive officers, make any necessary adjustments, and certify in its compensation committee report that the arrangements exclude incentives to take unnecessary and excessive risks that threaten the value of the financial institution;
- The compensation committee must meet annually with, and certify that it has met with, senior risk officers to review the relationship between risk management policies and the incentive compensation arrangements of senior executive officers;
- The company must have an ability to recover any bonus or incentive compensation earned by a senior executive officer that was based on statements of earnings, gains or other criteria that are later proven to be materially inaccurate;
- A prohibition on the company making any golden parachute payment to a senior executive officer upon involuntary termination or upon the insolvency, receivership or bankruptcy of the company;
- A limitation on the tax deduction that the company can take related to the senior executive officers' compensation;
- Requirement that the company and senior executive officers execute a waiver of any claims they might otherwise have a result of changes to compensation arrangements based on the TARP; and
- The principal executive officer must certify to the Treasury compliance officer within 120 days, and annually thereafter, that the compensation committee and the institution complied with the executive compensation requirements.

See our executive compensation Client Alerts "Treasury Ties Bailout Funds to Limits on Executive Pay," "The Emergency Economic Stabilization Act's Effect on Employee Benefits and Executive Compensation" and related articles, available at Financial Crisis Legal Updates and News.

Implementation Considerations

Key additional information will be posted on the TALF website in the coming days, including the initial subscription date and the form of master loan and security agreement. Updates to the program reflect significant input from market participants and the Federal Reserve's commitment to launching the program.

Although many sponsors of potentially eligible ABS have already agreed to the TARP executive compliance requirements, the TALF's additional compliance burden will require potential ABS issuers and potential TALF borrowers to work together to ensure borrowers are positioned to utilize the program. We expect ABS will be structured and issued specifically for eligibility as collateral under the TALF. The program also permits newly formed investment pools to qualify as eligible borrowers, if they satisfy the other requirements– primarily U.S. formation and control. We expect, given the recent market dislocations, many non-traditional AAA-ABS purchasers will evaluate the benefits of participating in the TALF.

Contacts

Amy Moorhus Baumgardner
(202) 887-1532
abaumgardner@mofo.com

Anna T. Pinedo
(212) 468-8179
apinedo@mofo.com

About Morrison & Foerster

With more than 1000 lawyers in 17 offices around the world, Morrison & Foerster offers clients comprehensive, global legal services in business and litigation. The firm is distinguished by its unsurpassed expertise in finance, life sciences, and technology, its legendary litigation skills, and an unrivaled reach across the Pacific Rim, particularly in Japan and China. For more information, visit www.mofo.com.