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Another Tool, Another Tack

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Secretary Paulson is fond of using the word "toolkit" to describe the various programs adopted as part of, or in conjunction with, the Emergency Economic Stabilization Act (EESA) enacted in early October. Yesterday, the Secretary announced the addition of another tool: Term Asset-Backed Loan Facility (TALF).

TALF is designed to generate liquidity for issuers and holders of consumer non-mortgage, asset-backed paper covering asset classifications as diverse as credit card loans, auto loans and student loans and also includes SBA small business loans. TALF will provide the opportunity to finance these assets during a period when the sale of asset-backed securities is a practical impossibility. All U.S. persons are eligible borrowers including an entity that has a non-U.S. parent. The total amount of this facility will be $200 billion.

Instead of buying these securities, the Federal Reserve Bank of New York, acting under the authority of the Federal Reserve Act, will make loans collaterized by these types of securities, thereby freeing up capital for fresh loans to consumers. The goal is to make affordable credit more available and to encourage the consumer to use that availability.

These non-recourse, one-year loans would be made monthly through a competitive bidding process with a potential borrower submitting bids for amounts and interests rate spreads over the applicable overnight index swap rate. Each borrower will submit its bid through a primary dealer and deliver its eligible collateral to a clearing bank. The collateral must be highly-rated asset-backed securities in the targeted asset classifications and will be subject to established haircuts. Payments received on the collateral will have to be

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used to repay the loans. The New York Fed will transfer the loans and the responsibility for management of the assets to a newly created special purpose vehicle.

This program is tied to TARP in at least two ways: Borrowers must agree to the limitations placed on executive compensation set by EESA and imposed upon banks in the CPP facility; and the new special purpose vehicle will borrow $20 billion from the Treasury TARP facility in return for the issuance of subordinated debt to absorb the first losses on the TALF facility.

Both the Terms and Conditions for TALF and the Treasury's press release suggest that the TALF program may be extended to other asset classifications such as commercial asset-backed securities. It is assumed that the Treasury and the Federal Reserve are testing these waters in anticipation of severe stress in the CMBS market because of upcoming loan maturities in a credit environment that will not permit borrowers to refinance on affordable terms.

In a separate but related move, the New York Fed announced that it would purchase $100 billion of debt from the GSEs and the Federal Home Loan Banks in an attempt to drive down long term residential mortgage rates into more affordable territory. This is a prelude to a $500 billion facility to be created at a later date.

TALF has a stated expiration date of December 31, 2009.

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