

Treasury and Federal Reserve Extend TALF Subscription Period

March 16, 2009

Background

In November 2008, the Treasury Department and the Federal Reserve announced the Term Asset-Backed Lending Facility program (TALF) with the goal of improving credit market conditions for consumers and small businesses by providing attractive financing to investors who purchase certain asset-backed securities (ABS) that meet the requirements set forth below.

On March 3, 2009, the Treasury Department and the Federal Reserve announced that the Federal Reserve Bank of New York (the New York Fed) will lend up to \$200 billion to “eligible borrowers” to finance such borrowers’ ABS purchases. The New York Fed will begin accepting subscriptions for the first round of funding at 10:00 a.m. ET on March 17, as previously anticipated; however, the New York Fed has extended the period during which it will accept subscriptions through 5:00 p.m. ET on March 19 in order to allow potential borrowers more time to complete the required documentation. After the first funding, TALF will provide additional fundings on a monthly basis through December 2009 (or longer if the Federal Reserve chooses to extend TALF). Each TALF loan will have a term of three years, will be for an amount no less than \$10 million, will be limited-recourse to the eligible borrower, and will be fully secured by the “eligible collateral.”

Borrower and Collateral Eligibility Requirements

An “eligible borrower” is defined as:

- Any U.S. company (including a U.S. subsidiary of a foreign company) that owns eligible ABS so long as such U.S. company is not controlled by a foreign government
- Any U.S. branch or agency of a foreign bank that maintains reserves with the Federal Reserve Bank and that owns eligible ABS so long as it is not controlled by a foreign government
- Any pooled investment fund (including any hedge fund, private equity fund, or mutual fund) organized in the United States and managed by an investment manager whose principal place of business is in the United States so long as such investment fund is not controlled by a foreign government or managed by an investment manager that is controlled by a foreign government

In order for ABS to be “eligible collateral,” they must meet the following requirements:

- They must be U.S.-dollar-denominated cash (i.e., nonsynthetic) ABS issued on or after January 1, 2009 that are cleared through the Depositor Trust Company and the underlying loans of which are owed by U.S.-domiciled obligors

- They must have received the applicable rating agency’s highest long-term or short-term credit rating, as applicable, from at least two of the following ratings agencies: Fitch Ratings, Moody’s Investors Service, and Standard & Poor’s
- They must not have received a credit rating from any such ratings agencies below their highest long-term or short-term credit rating or have been placed on watch for a downgrade
- Their underlying credit exposures must be one of the following (at least initially):
 - Auto loans (including retail car, light truck, recreational vehicle, and motorcycle loans and leases) that were originated on or after October 1, 2007 and have an average life of no more than five years
 - Auto dealer floorplan loans where the new ABS is issued to refinance existing auto dealer floorplan ABS maturing in 2009 and the amount of the new ABS is no greater than the amount of the maturing ABS
 - Student loans (including federally guaranteed loans, private loans, and consolidation loans) that were first disbursed on or after May 1, 2007
 - Consumer and corporate credit card receivables where the new ABS is issued to refinance existing credit card ABS maturing in 2009 and the amount of the new ABS is no greater than the amount of the maturing ABS
 - Small business loans fully guaranteed as to the principal and interest by the U.S. Small Business Administration where the SBA Pool Certificates and Development Company Participation Certificates have been issued on or after January 1, 2008 or the eligible small business ABS was originated on or after January 1, 2008, as applicable
- They must not be backed by loans that were originated or securitized by the applicable borrower or one of its affiliates

Haircuts to Be Applied to Eligible Collateral

Sector	Subsector	ABS Expected 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 lease	9%	10%	11%	12%	13%		
Auto	Dealer Floorplan	12%	13%	14%	15%	16%		
Auto	RV/Motorcycle	7%	8%	9%	10%	11%		
Credit Card	Prime	5%	5%	6%	7%	8%		
Credit Card	Subprime	6%	7%	8%	9%	10%		
Student Loan	Private	8%	9%	10%	11%	12%	13%	14%
Student Loan	Gov’t Guaranteed	5%	5%	5%	5%	5%	6%	6%
Small Business	SBA Loans	5%	5%	5%	5%	5%	6%	6%

Current Status of TALF/Potential Issues

The principal documentation (including the Master Loan and Security Agreement that will be entered into among the New York Fed, the primary dealers acting on behalf of the eligible borrowers, the loan administrator, and the collateral custodian, and the form of Customer Agreement to be entered into between the applicable primary dealer and the agent for the eligible borrowers) is being drafted and negotiated now. The Managed Funds Association, the leading association for hedge funds, has been

reviewing and commenting on the documents. There are several key provisions that are currently being negotiated in the principal documentation that should be considered carefully by ABS investors/potential TALF borrowers.

The provisions relating to the nature and extent of the limited recourse provisions are of primary concern for ABS investors (and potential TALF borrowers) as they will affect the economics of the deal for ABS investors. In particular, the proposed time for replacement of ineligible collateral is only five days, and if the ineligible collateral is not replaced in that time, the loan becomes recourse. This places a huge due diligence burden on ABS investors/TALF borrowers. This will likely be solved in part by representations from the structuring investment bank as to eligibility and put-back rights to originators. Similar put-back rights became problematic in 2007 and 2008 in an analogous situation when thinly capitalized mortgage originators were unable to buy back loans as to which their representations were untrue. This resulted in a large amount of litigation that was unsatisfactory in producing funds due to the lack of equity in the originators.

We see two significant problems that the program may face: (1) finding buyers for the lower-rated tranches of the structure and (2) remaining desirable to issuers that retain equity, since the program requires issuers to retain fatter layers of equity. If the AAA tranche is in the 70% to 80% range, which could be high, there will be real tension for issuers if the amount of equity they retain is enough so that the structure as a whole has advance rates that are close to those of typical bank lending arrangements against receivables. There may be new thinking that needs to be applied to true sale issues.

In addition, there is no limit to the number of loans a potential investor may obtain and a potential investor may obtain loans through multiple dealers; therefore it will be important to ensure that each loan is treated separately (e.g., in terms triggers for repayment) so that, for example, the issuance of a downgraded rating for one ABS will not affect any other TALF loan that a borrower may have. Issues regarding timing requirements relating to when a loan funding closes versus when a potential TALF borrower acquires the ABS securities, as well as regarding ensuring as a general matter that the obligations and representations contained in the form of Customer Agreement are consistent with and do not exceed those contained in the form of Master Loan and Security Agreement, are under negotiation and also should be reviewed carefully by any potential TALF borrower.

Key Differences Between TALF and TARP

Potential participants in the TALF program have voiced fears that they could end up like the recipients of capital investments made pursuant to the Troubled Assets Relief Program (TARP), subject to limits on executive compensation and dividends. Or worse, they fear that they could close what they think is a final deal and then have the deal become subject to the whims of congressional amendment. Potential investors should recall, however, that the initial compensation restrictions and dividend limits were baked into the TARP Securities Purchase Agreement, as was a very unusual provision permitting unilateral amendment of the terms by the Department of the Treasury “to the extent required” to comply with any changes after the Signing Date in applicable federal statutes post-closing. As it is now clear that Congress will not hesitate to micromanage TARP and its recipients, potential TALF investors should be certain that the TALF terms and conditions to which they agree do not materially affect the way they do business, and contain no “unilateral amendment” provisions. For now, the Master Loan and Security Agreement proposed by the New York Fed provides that no amendment to the original agreement shall affect the rights or obligations of any borrower with respect to any loan outstanding prior to the amendment, though the New York Fed may amend the agreement unilaterally at any time as to future obligations.

Also, unlike TARP, which is a component of the Emergency Economic Stabilization Act of 2008, the TALF program is authorized under Section 13(3) of the Federal Reserve Act, so it is unclear what role, if

any, the guardians of TARP funds (such as the Financial Stability Oversight Board, Special Inspector General Neil Barofsky, the GAO, and the Congressional Oversight Panel) will have on TALF. In addition, the Treasury Department and the Federal Reserve intend to seek legislation to give the Federal Reserve additional tools and funding for TALF, so public hearings on the TALF will be in the offing. Public opinion will undoubtedly translate into political heat should the Federal Reserve be viewed as overvaluing these assets, but the true test will come when and if the older, “toxic” assets are purchased under TALF.

Potential Expansion of TALF

The Treasury Department and the Federal Reserve have already agreed to expand TALF to increase the amount of money available for lending to up to \$1 trillion. In addition, there is already speculation that they will also expand the categories of loans that comprise the eligible ABS to include equipment loans and leases, collateralized debt obligations, corporate loan investment vehicles, and commercial mortgage-backed securities. The Treasury Department and the Federal Reserve are currently evaluating the benefits and drawbacks to expanding the category of newly issued ABS eligible to serve as collateral for TALF loans. Inclusion of these expanded types of underlying loans will likely necessitate changes to the terms and conditions (e.g., longer term loans) currently applicable to TALF loans.

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