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SECURITIZATION UPDATE

US Federal Reserve Announces Programs to Reduce Consumer Borrowing Costs; Extends Earlier Liquidity Measures

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On November 25, 2008, the US Federal Reserve announced two new programs aimed at enhancing the availability, and lowering the cost, of consumer finance and small business loans:

- A Term Asset-Backed Securities Loan Facility (TALF) that will help private sector lenders to finance consumers and small businesses by supporting the issuance of asset-backed securities (ABS) collateralized by student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration (SBA). The TALF is the main subject of this update and is discussed further below.
- A program to purchase direct debt obligations of Fannie Mae, Freddie Mac and the Federal Home Loan Banks, as well as mortgage-backed securities (MBS) guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae. This program is meant to reduce the cost and increase the availability of credit for residential mortgage loans. It was initiated in reaction to appreciable widening in spreads on the subject securities. Under the program, the Federal Reserve will purchase up to $100 billion in direct debt obligations through primary dealers (starting the week of December 1) and up to $500 billion in MBS through asset managers to be selected via a competitive process (with purchases meant to start by year end). The Federal Reserve expects to make both types of purchases over several quarters. Further details are being worked out in consultation with market participants.

Also, on December 2, the Federal Reserve extended the terms of three liquidity facilities established earlier this year:

- The Primary Dealer Credit Facility, which provides discount window loans to primary dealers;
- The Asset-Backed Commercial Paper Money Market Fund Liquidity Facility, which provides loans to depository institutions to purchase asset-backed commercial paper from money market mutual funds; and
- The Term Securities Lending Facility, under which the Federal Reserve Bank of New York (FRBNY) auctions term loans of Treasury securities to primary dealers.

Initially authorized through January 30, 2009, these three facilities have been extended through April 30, 2009. This brings them in line with the authorized term of the Federal Reserve's Commercial Paper Funding Facility (which provides a liquidity backstop to US issuers of commercial paper), the Money Market Investor Funding Facility (which supports a private-sector initiative to provide liquidity to US money market investors) and temporary reciprocal currency swap lines with 14 other central banks.

More on the TALF[1]

New issuance of ABS ground to a halt in October as spreads on the highest rated ABS tranches soared well above their historical range. This cut off an important source of funding for consumer credit and SBA-guaranteed small business loans. The TALF is meant to increase credit availability and support economic activity by facilitating renewed issuance of consumer and small business ABS at more normal spreads. To do this, the FRBNY will encourage investment in high quality ABS by offering up to $200 billion in loans to finance these investments on terms that are meant to be attractive to investors.

Basic Loan and Program Terms. TALF loans will initially have a one-year term (which the FRBNY may decide to lengthen later) and be made on a secured, non-recourse basis. Pricing will be determined by a competitive auction (see Allocation and Bid Process below) and will include an upfront loan fee. The FRBNY will establish initial advance rates for each class of eligible collateral based on price volatility. There will be no requirement to mark collateral to market or re-margin, which should reduce investor concerns about the impact of price volatility. Substitution of collateral will not be allowed. Principal or interest distributions on the collateral must be used to pay interest due on, or reduce the principal amount of, the TALF loan. No TALF loans will be made after December 31, 2009, unless the Federal Reserve Board decides to extend the facility.

Eligible ABS. Each TALF loan will be secured by traditional (as opposed to synthetic) ABS that must:

- Be denominated in US dollars;
- Have long-term credit ratings in the highest investment-grade category (for example, AAA) from two or more major rating agencies and may not have a long-term credit rating of below the highest investment-grade category from any major rating agency.
- Be backed by credit exposures, all or substantially all of which are newly or recently originated exposures to US-domiciled obligors in the form (initially) of auto loans, student loans, credit card loans or small business loans guaranteed by the SBA. Because credit card loans are securitized through revolving master trust structures that combine old and new balances, some adjustment to the newly-or-recently-originated requirement will be needed to accommodate these structures. The eligible credit exposures may be expanded later to include residential or commercial mortgages or other asset classes.

Also, the originator of the underlying credit exposures (or the sponsor of the ABS in the case of SBA-guaranteed loans) must have agreed to comply with, or otherwise be subject to, executive compensation requirements that are consistent with the Treasury's Troubled Assets Relief Program (TARP) guidelines applicable to its Capital Purchase Program.

Eligible Borrowers. Loans will be available to "US persons," defined as a natural person that is a US citizen, a business entity that is organized under the laws of the United States or a political subdivision or territory thereof (including such an entity that has a non-US parent company), or a US branch or agency of a foreign bank. However, the borrower must not be either the originator of the credit exposures underlying the collateral ABS or an affiliate of the originator.

Relationship with TARP. The TALF program leverages funds available under TARP. Up to $20 billion of TARP funds will be available to absorb losses that the FRBNY might otherwise incur with respect to ABS that is pledged as collateral for TALF loans. The mechanism for closing out TALF loans in the event of non-payment has not yet been specified, but the FRBNY will create a special purpose vehicle (SPV) to purchase and manage any ABS received by the FRBNY in these circumstances. The FRBNY will have the right to put ABS to the SPV at a price equal to the outstanding balance of the related TALF loan, plus accrued and unpaid interest. The Treasury will provide TARP funds to finance the first $20 billion of asset purchases. If the FRBNY puts more than $20 billion in ABS to the SPV, the FRBNY will lend additional funds to the SPV to finance the purchases. Any such loan by the FRBNY to the SPV will be senior to the financing provided with TARP funds and will be secured by all the SPV's assets.

Allocation and Bid Process. The FRBNY will award a fixed amount of TALF loans to borrowers each month, with allocation based on a competitive, sealed bid auction process. However, the FRBNY will reserve the discretion to reject any bid, in whole or in part, based, among other things, on the potential riskiness of the proposed collateral. Bids must be made through a primary dealer, which will act as agent for the prospective borrower. Collateral will be held at clearing banks.

Endnote

1 The details described here are as set out in the initial press release and accompanying term sheet, which are available at http://federalreserve.gov/newsevents/press/monetary/20081125a.htm. The Federal Reserve has reserved the right to modify these details as the program moves towards launch.

For more information about TALF, TARP, or any other matter raised in this Update, please contact the Mayer Brown lawyer with whom you regularly communicate, or one of the following lawyers. To learn more about our Securitization practice, please visit http://www.mayerbrown.com/securitization/overview/index.asp.

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