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Federal Reserve and Treasury Announce a New Facility to Provide Liquidity for Asset-Backed Securities

In recent remarks, Secretary of the Treasury Henry M. Paulson, Jr. has indicated that the Treasury would turn its attention under the Emergency Economic Stabilization Act to the market for consumer credit that is securitized outside the banking system. On November 25, 2008, the Federal Reserve and the Treasury announced a joint program to provide liquidity to this market. The program will take several months to implement, and any benefits to consumers and small businesses may not be apparent until sometime in 2009.

The Term Asset-Backed Securities Loan Facility ("TALF") is intended to increase the supply and reduce the cost of consumer and small business credit. Its premise is that credit to these borrowers has been choked off because investors are reluctant to purchase asset-backed securities ("ABS") backed by such loans, based more on concern about the securities' lack of liquidity than the underlying credit risk. To address the liquidity problem and the credit squeeze, TALF will make non-recourse loans secured by qualifying ABS to U.S. investors. It will not purchase qualifying ABS directly from issuers. To qualify, the ABS must be investment-grade, have a term of one year or longer and be backed by "newly or recently originated" credit card loans, auto loans, student loans and loans to small businesses guaranteed by the U.S. Small Business Administration. TALF loans will be offered monthly through a closed-bid auction process. The Federal Reserve will make available up to $200 billion, including $20 billion provided by the Treasury.

Several terms and features of TALF remain to be worked out, with market input invited. Among the issues to be addressed are how to value eligible ABS, the "haircut" or level of overcollateralization that will be required for various types of ABS, benchmark interest rates for TALF loans, program fees, the lending limit for each participating investor and the age limit for newly or recently originated loans. In view of the complexities of the program, the Federal Reserve does not expect to have TALF operating before February 2009. It will remain open through December 31, 2009.

Under TALF as currently described, in the event that a participating investor cannot repay a loan, or does not repay a loan because the collateral has declined in value to the point that it is

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worth less than the loan payoff amount, that investor would incur no financial obligation beyond the loss of the collateral. The loss by TALF will be absorbed first by the haircut on the collateral, second by the Treasury contribution, third by the program fees and last (but not least) by the Federal Reserve.

While the Federal Reserve and the Treasury's stated purpose for establishing TALF is to help consumers and small businesses to recover, participating investors are receiving treatment as the patient. TALF will dispense loans impartially to investors in qualifying ABS, which is expected to encourage issuers and downstream lenders to make new loans. Under this program, the Federal Reserve is seeking to avoid directing how loans are made, but the trade-off in a circuitous process is a loss of efficiency in the transmission of funds to the ultimate borrowers. TALF will directly support investor participation in the ABS market, but the indirect benefit to the ultimate borrowers will depend on many intervening factors, including lenders' assessment of credit risk and the effect on lending standards and rates of the availability of TALF funds. TALF should not be viewed as a program intended to aid a targeted group of borrowers because that is not what the Federal Reserve as a monetary authority does. The Federal Reserve is aiming TALF in the direction of "Main Street," but it remains to be seen how much of its benefits reach that destination.

Authors and Contributors

For more information, please contact your usual Fried Frank attorney or the attorney listed below:

Washington, DC

Thomas P. Vartanian
+1.202.639.7200

David L. Ansell
+1.202.639.7011

Robert H. Ledig
+1.202.639.7016

Gordon L. Miller
+1.202.639.7173

Fried, Frank, Harris, Shriver & Jacobson LLP

New York
One New York Plaza
New York, NY 10004-1980
Tel: +1.212.859.8000
Fax: +1.212.859.4000

Washington, DC
1001 Pennsylvania Avenue, NW
Washington, DC 20004-2505
Tel: +1.202.639.7000
Fax: +1.202.639.7003

Frankfurt
Taunusanlage 18
60325 Frankfurt am Main
Tel: +49.69.870.030.00
Fax: +49.69.870.030.555

Hong Kong
in association with
Huen Wong & Co.
9th Floor, Gloucester Tower
The Landmark
15 Queen's Road Central
Hong Kong
Tel: +852.3760.3600
Fax: +852.3760.3611

Shanghai
40th Floor, Park Place
1601 Nanjing Road West
Shanghai 200040
Tel: +86.21.6122.5500
Fax: +86.21.6122.5588

Fried, Frank, Harris, Shriver & Jacobson (London) LLP

London
99 City Road
London EC1Y 1AX
Tel: +44.20.7972.9600
Fax: +44.20.7972.9602

Fried, Frank, Harris, Shriver & Jacobson (Europe)

Paris
65-67, avenue des Champs Elysées
75008 Paris
Tel: +33.140.62.22.00
Fax: +33.140.62.22.29

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