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## TALF (Term Asset-Backed Securities Loan Facility): Issues for Borrowers and Investors

On February 18, the Federal Reserve Bank of New York (the "New York Fed") published the Master Loan and Security Agreement ("MLSA") for the previously announced Term Asset-Backed Securities Loan Facility ("TALF"). TALF was designed to jump-start lending markets by providing government loans to investors who purchase qualifying asset-backed securities ("ABS"). The Obama administration recently increased the size of TALF to up to \$1 trillion (to be funded with \$200 billion from the Troubled Asset Relief Program and up to \$800 billion from the New York Fed).

TALF has generated an enormous amount of interest in the investor community. We have highlighted some key elements of TALF below and identified select issues to be considered by those interested in participating in TALF. As additional details emerge, we will continue to update you.

Key elements of TALF include:

- **Three-year, non-recourse loans:** The New York Fed will extend three-year loans to eligible U.S. companies as borrowers. TALF loans will be non-recourse to the borrowers except for breaches of certain representations, warranties and covenants specified in the MLSA.
- **AAA collateral only:** Each TALF loan will be fully secured by the senior most tranche of qualifying ABS. Eligible collateral excludes ABS that obtain credit ratings based on the benefit of a third-party guarantee or ABS that has been placed on review or watch for a downgrade.
- **AAA collateral must be from newly packaged qualifying ABS transactions:** Eligible ABS must be issued on or after January 1, 2009 (except in limited circumstances) and all or substantially all of the credit exposures underlying eligible ABS must be exposures to U.S.-domiciled obligors. Additional information concerning the eligible ABS can be found on Annex 1. The asset classes currently qualifying as collateral for TALF loans are:
  - Commercial mortgage-backed loans,
  - Auto loans,
  - Student loans,
  - Credit card loans, and
  - Small business loans that are fully guaranteed as to principal and interest by the U.S. Small Business Administration.

- **Borrower can choose between fixed or floating interest rates but they must match the interest rate profile of the underlying collateral:** Interest on TALF loans will be payable monthly and borrowers can choose between fixed or floating interest rates, however, fixed rate ABS must be pledged against a fixed rate loan and floating rate ABS must be pledged against a floating rate loan. The fixed interest rate on TALF loans will be 100 basis points over the three-year LIBOR swap rate and the floating interest rate will be 100 basis points over one-month LIBOR.
- **The NY Fed will apply haircuts depending upon the type and expected life of pledged ABS:** Under TALF, the NY Fed will lend to each borrower an amount equal to the value of the pledged ABS minus a haircut. The haircuts are subject to ongoing review by the NY Fed and currently range between 5-16% depending upon the type and expected life of the pledged ABS.

For the NY Fed TALF website, please see <http://www.newyorkfed.org/markets/talf.html>.

Issues for investors and borrowers under TALF include the following:

***Only the most senior tranche directly benefits from TALF***

The security for a TALF loan can only include collateral that (i) has a credit rating in the highest long-term or short-term investment grade rating category from two or more major nationally recognized statistical rating organizations (“NRSROs”) and (ii) does not have a credit rating below the highest investment-grade rating category from a major NRSRO (collectively, the “AAA Tranche”). The purpose of limiting collateral to the AAA Tranche is to protect taxpayers against losses. A stated goal of TALF is to facilitate the issuance of consumer and small business ABS at more normal interest rate spreads. In order for an issuer to securitize a pool of assets at a commercially acceptable price, however, it is important that a liquid market exist for the entire capital structure so the tranches of debt and equity supporting the AAA Tranche are not so expensive as to render the entire structure economically inefficient. It is unclear, however, that providing liquidity to the AAA Tranche of securitizations will facilitate new issuances of consumer and small business ABS. TALF loans do not address the senior subordinated, mezzanine or subordinate debt tranches or equity portions of a securitization’s capital structure. If the AAA Tranche is the only portion of the capital structure that benefits from a liquid market, the tranches of debt and equity supporting such AAA Tranche may be priced in such a way as to be prohibitively expensive to issuers.

***Credit ratings remain a key element of any TALF loan analysis***

Credit ratings from major NRSROs remain a key element of the analysis as to whether collateral will qualify for purposes of a TALF loan because the collateral that may be pledged is limited to the AAA Tranche. This raises a number of potential issues for borrowers in the TALF program. Structures of AAA Tranches may differ from existing structures in the marketplace because eligible collateral will not include ABS that obtain credit ratings based on the benefit of a third-party guarantee. In addition, it is unclear whether placing so much importance upon major NRSRO credit ratings will aid or inhibit the use of the TALF loans. Potential borrowers in the TALF program – and any investors in structures where the AAA Tranche has been financed through a TALF loan – will want to carefully evaluate how the AAA Tranche ratings will be achieved.

***The New York Fed SPV, as the potential controlling class, will be a new market participant in ABS***

The borrower under a TALF loan will pledge the AAA Tranche to the New York Fed as collateral. The New York Fed will in turn create a special purpose vehicle (“New York Fed SPV”) to purchase and manage any assets received by the New York Fed in connection with any TALF loans. As a result, investors who purchase the non-AAA Tranches (including equity) in a securitization that has been financed through a TALF loan will need to consider that TALF introduces a new market participant in ABS. Determining how and when the New York Fed

SPV may control a transaction will be an important consideration for investors in these transactions. For instance, it is unclear how the New York Fed SPV may act in the event a deal defaults, e.g., whether it will immediately seek to liquidate collateral to minimize potential losses or agree to work with issuers and other creditors to restructure transactions in ways to forestall liquidation.

***Potential refinancing risks may arise due to potential mismatches in tenor of TALF loans and underlying collateral***

TALF loans will have a three year tenor and are prepayable in whole or in part at the option of the borrower. In the past, securitizations frequently had senior tranches with maturities significantly longer than three years. Therefore, new structures will either reflect a three year tenor for the AAA Tranche or, perhaps more likely, AAA Tranches will have maturities exceeding three years. If there is a maturity mismatch between the TALF loan and the AAA Tranche that is pledged as security for such a loan, borrowers in TALF loans must be aware of the refinancing risk inherent in such a mismatch. Although TALF loans are generally non-recourse to the borrower, the proposed collateral haircuts are not insignificant and therefore a TALF borrower may have a sizable equity stake in the AAA Tranche. In the event the TALF borrower does not want to surrender the collateral to the NY Fed when the TALF loan matures, it will need to refinance the TALF loan. In the event the TALF borrower surrenders the collateral when the loan matures, the TALF borrower risks losing its entire equity stake in the AAA Tranche if the collateral has underperformed and the borrower has not recouped its equity investment during the term of the TALF loan.

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We have been following these issues closely and have spoken with many of you about them. We will continue to provide you with further updates as details emerge about the TALF loan program and other related U.S. Government programs.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. If you have any questions, or would like to discuss any of the foregoing in further detail, please feel free to call any of the following Paul, Weiss Financing Group lawyers:

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## Annex 1

## CERTAIN ABS ELIGIBILITY CRITERIA

All or substantially all of the credit exposures underlying eligible ABS must:

- have been originated on or after October 1, 2007 (in the case of auto loan ABS (except auto dealer floorplan ABS));
- have had a first disbursement date on or after May 1, 2007 (in the case of student loan ABS);
- have been issued on or after January 1, 2008 (in the case of SBA Pool Certificates and Development Company Participation Certificates);
- have been originated on or after January 1, 2008 (in the case of SBA-guaranteed credit exposures underlying all other eligible small business ABS); and
- with respect to eligible credit card and auto dealer floorplan ABS, be issued to refinance existing credit card and auto dealer floorplan ABS, respectively, maturing in 2009 and must be issued in amounts no greater than the amount of maturing ABS.

“Substantially all” in the context of credit exposures of underlying ABS is defined as 85% or more of the dollar amount of the underlying credit exposures.