

TALF: Jumper Cables Searching for a Dead Battery

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Assuming for the sake of argument that market moves can ever be attributed to any single cause in a complex global economy, Treasury Secretary Geithner's recently proposed "Financial Stability Plan," was not well received by the market, which dropped 5% immediately after the Plan was announced. The US Treasury has posted a seven-page Fact Sheet describing the Financial Stability Plan, which consists of six elements and will involve an investment by US taxpayers and private parties of the princely sum of \$2.5 trillion.

Time, and my editor's long-suffering patience, would surely defy any effort to describe and discuss the merits of the entire Financial Stability Plan in this column. Instead, we will only deal with Item 3 of the Plan: "The Consumer & Business Lending Initiative – Up to \$1 Trillion."

The financial press, and various political commentators with a new-found expertise in economics, found fault with the Financial Stability Plan for failing to provide specifics. The Consumer and Business Lending Initiative does not suffer this deficiency because it amounts to an expansion of TALF, an initiative proposed by the Federal Reserve Bank in November 2008 and modified in December. TALF is an acronym, which stands for "Term Asset-Backed Securities Loan Facility."

For many years, banks have acted more or less as introducing lenders. They would make commercial and consumer loans of various types—business loans, credit card receivables, student loans and auto loans, in addition to mortgage loans—and sell them into pooled investment vehicles. The pooled investment vehicles would issue securities that could then be purchased by non-bank investors. The securities were called "asset-based securities" because they were secured by the loans (assets) in the pool. Loans sold to the pool were no longer assets of the bank, and that freed up capital to make more loans. The US Treasury estimates that approximately half of all of the commercial and consumer loans in the United States are owned by such pooled investment vehicles.

Around July 2008, the market for asset-backed securities secured by real estate mortgages (collateralized mortgage obligations or CMOs) dried up entirely. By October 2008, the production of new pools for all types of commercial and consumer loans had ceased. These are the circumstances that led to the institution of the TALF program.

The concept is relatively simple. The Federal Reserve Bank will make low interest rate loans to any US person who wishes to buy certain asset-backed securities (ABS). There is no maximum amount that can be borrowed, but the minimum is \$10 million. Fixed and floating rates are available. TALF loans have up to a three-year term. The amount of the loan will vary depending on the nature of the collateral underlying the ABS. The Fed will lend as much as 95% of the par value of ABS issued by pools of guaranteed student loans, and as little as 84% of the par value of ABS from pools of Auto Floorplan loans.

The TALF loans are non-recourse, which means that if the borrower fails to pay, the Fed will seize the ABS for payment, but will not otherwise seek repayment of the loan from the borrower. The current TALF program was intended to commit up to \$200 billion in loans from the Fed, with the US Treasury expected to be responsible for \$20 billion to purchase seized ABS from the Fed when a borrower has failed to pay. So, \$20 billion of potential cost provides \$200 billion in total financing. The US Treasury is effectively leveraging the taxpayer's funds 10 to 1.

The existing TALF program is intended to jump-start a defunct market, rather than to clean up the financial mess of devalued ABS already held by financial institutions. Therefore, the TALF program is limited to ABS issued after January 1, 2009.

So far, nobody has produced any. TALF is a song without a melody.

Treasury apparently was determined that the US taxpayer would not take a hit on the TALF program. So, TALF loans were authorized only for the purchase of ABS that have received the highest long-term or short-term investment-grade rating by two or more major nationally recognized statistical rating organizations (NRSROs) and that also have not received any lower credit rating from any other major NRSRO. And, that platinum rating has to be made without the benefit of any credit insurance. These have to be true AAA-rated securities.

In addition, TALF is not interested in CMOs, even if they are AAA-rated. The current TALF program covers auto loans, small business loans, credit card receivables and student loans.

Mr. Geithner's Financial Stability Plan would ratchet the amount committed to the program up to \$1 trillion with the US Treasury proving support for \$100 billion. In addition, Mr. Geitner would expand the program to include ABS backed by commercial real estate mortgages. The US Treasury would continue to consult with the Fed about the desirability of expanding the program to ABS backed by residential mortgages and corporate debt.

As always, the devil is in the details. For now, it looks as if Treasury's zeal to protect the US taxpayer has resulted in a fascinating mirage: massive federal financing that nobody wants.

The investment banking game played with asset-backed securities was to convince the rating agencies to classify the largest possible portion of any particular pool as AAA-rated. The reason for this is that an AAA-rated ABS was relatively easy to sell. Other, lower-rated portions of the pool were much more difficult to sell, and the residual, known affectionately as "toxic waste," could not be sold at all and generally remained on the books of the loan originator or the underwriter.

To produce more AAA-rated securities from the same pool of loans, the originators would secure financial insurance so that more of the pool could be rated AAA. Then they would take the remainder of the pool, which received an inferior rating, and combine it with the lower-rated securities of other pools to make other pools. Using statistical models, the originators generally were able to "prove" to the rating agencies that because of its diversity, as much as 90% of the ABS issued from a resulting pool of lower-rated securities also should receive an AAA rating. It is the second-tier AAA-rated securities of these resulting pools that, now drastically downgraded, have been responsible for much of the clogging of the financial system.

If the government really wants to "jump start" the industry that until a few months ago was churning out one issuance of ABS after another, it should invest in the lower-rated securities produced by the pools or even, God forbid, in the toxic waste. Investment bankers probably don't need much help marketing the truly AAA stuff.

The US Treasury is between a rock and a hard place. The current TALF program, in my view, will have no customers. Since any multiple of zero is still zero, Mr. Geithner's expansion of the program will also have no customers unless the program can be targeted to supporting lower tiers of the pools or used to finance acquisition of pre-2009 ABS that are dragging down the balance sheets of banks. On the other hand, although an expansion of the program to cover lower-rated securities probably would have customers, the taxpayer would have a lot more skin in the game, investment bankers would get rich, and we would find ourselves on the roller-coaster ride to another financial crisis even worse than this one.

Wise policy or not, it is foolish to stand against the market, even a market artificially created by generous government programs. If there is anything to purchase with the support of the TALF program, I expect to help my clients obtain the non-recourse loans offered by the Fed to qualified investors.

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