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Will TALF Stabilize U.S. Financial Institutions By Revitalizing Securitization?

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Will TALF Stabilize U.S. Financial Institutions By Revitalizing Securitization?

Market hopes appear to be running high for the U.S. government's latest push to restart the securitization markets for consumer lending. If the Term Asset-Backed Securities Loan Facility, or TALF, is successful in attracting new investors, it could allow financial institutions to reduce their debt, freeing up their capital for new loans. Standard & Poor's Ratings Services believes TALF's potential returns will likely turn hedge funds into new buyers of asset-backed securities (ABS), although the facility may fall short of its stated lending potential of \$1 trillion due to certain restrictive terms and adverse market conditions. And to the extent TALF helps restore confidence in risk taking and helps establish prices for assets, it would be beneficial to bank ratings.

The revival of the securitization markets, which bundles and sells pooled loans that banks originate, is essential to getting financial institutions lending again. On March 25, 2009, the Federal Reserve Bank of New York will distribute to investors its first round of three-year financing under TALF to invest in 'AAA' ABS collateralized by credit card receivables, student loans, auto loans, and loans with Small Business Administration guarantees. (The Fed is considering conditions to expand the eligible ABS to include securitized loans for commercial mortgages, nonagency residential mortgages, heavy industrial equipment, agricultural-equipment leases, and rental-car fleets, among other asset classes.) We believe financial institutions, particularly cash-strapped auto finance lenders that typically have limited funding options other than ABS, stand to benefit. And banks, regardless of their need for more liquidity, may look to TALF as a means to diversify their funding.

Still, we see TALF as just one part of the government's proposed fixes for securitization, and not a panacea for the banking system's woes. Furthermore, most major financial institutions have ample access to liquidity through other government support programs, such as the Troubled Asset Relief Program, or depositors, at more favorable rates. Another issue will likely be a lack of risk transfer of subordinated ABS tranches, those below the 'AAA' government-guaranteed level. Banks' more prudent underwriting standards may make them reluctant to lend anew, cutting into potential supply. And consumers, for their part, have been more cautious on spending and debt, which could limit demand for car loans or credit cards. In the TALF terms, potential problem areas include transferability restrictions and maturity mismatches.

A Shot In The Arm For Auto Lenders

For financial institutions that have ample access to liquidity, TALF rates may not be very attractive. For institutions that have always relied on securitization for funding, the program should provide a boost. This is particularly true for auto lenders because the ability to secure funding at a reasonable cost has been nearly impossible given the credit squeeze on auto ABS. Overall, we believe the auto finance industry needs to confront crucial issues, including significantly reduced sales volumes, the need for a new funding/business model, deteriorating asset quality, and liquidity constraints.

According to The Wall Street Journal, several plans are already in line for the first round of TALF offerings: auto lender World Omni's expected \$750 million deal; a deal for auto-loan-backed securities from Ford Motor Credit Co.; and offerings from the finance arms of Nissan Motor Co. Ltd. and used-car retailer CarMax Inc.

Still, TALF lenders may face some difficulties. The ABS markets for these riskier instruments remain closed. So

although there may be some capital savings, we do not expect that there will be any significant risk transfer. In addition, banks may not be willing or able to make prudent new loans under TALF.

Transferability Troubles And Maturity Mismatches

Several factors could still temper investor demand, as well. Hedge funds are generally not averse to leverage investing--the use of various financial instruments or borrowed capital, such as margin, to increase the potential return of an investment. But many are suffering from poor performance and high investor redemptions. Other institutional investors may not be as willing or able to take on such leverage because using it to amplify returns also works in the opposite direction, amplifying potential losses.

Some money-market managers also appear to have potential concerns with the restricted transferability of the TALF investment: If the managers buy the assets subject to the federal loan, they are required to get regulatory approval prior to any resales--thereby impairing ABS market liquidity.

Another deterrent for investors may be maturity mismatches. The TALF is generally a three-year financing facility, so it doesn't cover the typically three-to-five year terms for auto loan, credit card, and student loan ABS. Commercial mortgage-backed securities, which is one of the asset classes to which the Fed is considering extending the program, typically have a five- or 10-year term. If the TALF isn't extended, this misalignment creates some refinancing risk for investors in these asset classes.

A Multi-Front War

We're monitoring not just TALF but a complete array of government fixes aimed at addressing various parts of the banking system and restarting the securitization markets. In November 2008, when TALF had a limit of \$200 billion, the Federal Reserve announced a plan to buy \$600 billion in mortgage loans from the government-sponsored mortgage finance enterprises (GSEs). Specifically, the central bank said it would purchase up to \$500 billion in mortgage-backed securities and up to \$100 billion in direct obligations from Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. These actions would "reduce the cost and increase the availability of credit for the purchase of houses, which in turn should support housing markets and foster improved conditions in financial markets more generally," the Fed said in a statement.

One issue with the GSE mortgage purchase program, in our view, is that it does not address the issue of alleviating financing availability for jumbo mortgages, which are typically mortgages for more than \$412,000. Conforming loans are already the dominant form of new loans made. The purchase program has helped drive down interest rates on mortgage loans, which is very helpful to the affordability of housing.

Another key initiative is U.S. Treasury Secretary Timothy F. Geithner's proposed Public-Private Investment Fund, which, like TALF, uses the public and private sectors as investing sources. The main difference is that the fund--up to \$500 billion initially with the ability to expand to \$1 trillion--encourages investors to buy severely distressed assets. In the process, the fund may also help to establish prices of difficult-to-value asset classes, putting a floor in the asset-quality deterioration and freeing up banks' balance sheets to make new loans.

A Limited Timeline

The government has committed to making loans under TALF through Dec. 31, 2009. We think financial institutions will avail themselves of TALF, and it will restore liquidity to the market, at least for as long as the program is in place. The real question at the end of 2009 will be whether the securitization markets, to the extent that they have recovered, will be able to function without the government financing and guarantees. Longer term, the problem will be how lenders get weaned off government-sponsored lending. Of course, a revival in securitized lending alone won't likely bring an end to the credit market's downturn, but it's an essential step in restoring banks' lending capacity, and ultimately the health of banks and the financial system.

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