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TALF -- The Fed Gets One Right

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The Fed is making the securitization market an offer it can't refuse.

While it may seem insane to say so on another day in which stocks make new lows, the Term Asset-Backed Securities Loan Facility (TALF) finally unveiled this week by the Fed and Treasury probably has the potential to do more to free up the credit markets and begin warming up the economy's growth engines than any government action that's been taken to date. The delay in launching the program -- it was first announced last November, yet the first funds won't be disbursed until late this month -- was more evidence of the confusion surrounding much of the federal effort to resolve the financial crisis, sapping market confidence (see "Citi's Common Misconception" March 2, 2009). But assuming it gets underway without any glitches, we see the TALF as key to dealing with the breakdown of the securitization markets and possibly as a template for the Treasury in finally identifying a mechanism that can relieve the toxic asset overhang clogging the banking system's balance sheet.

Update to strategic view

US BONDS: The TALF program is probably the single most positive government initiative yet launched during this seemingly interminable period of credit market crisis. The Fed is offering investors a deal that's too good to refuse, to encourage purchases of asset-backed securities and unlock the securitization markets.

[see Investment Strategy Dashboard]

The program will offer investors such as hedge funds and private equity funds highly appealing terms on three-year non-recourse loans to purchase newly issued AAA-rated asset backed securities with the Fed absorbing the bulk of the downside risk. The Fed is slated to provide $1 trillion in TALF loans, backed by $100 billion in TARP funding from Treasury, with most fixed rates loans set at the three-year LIBOR swap rate plus 100 bp or floating rates at one-month LIBOR plus 100 bp.

It's estimated that the impairment of the securitization markets since last year has meant a loss of financing amounting to about $1 trillion. The Fed is putting itself in a position of underwriting a significant re-leveraging of the so-called "shadow banking system." Investors, for example, can borrow $95 million to purchase $100 million of prime credit card loans. That would represent a leveraging of 20 times equity, with the 5% haircut accounting for the only downside risk. Leveraged returns in the range of 20% are envisioned, depending on the size of the haircut, which will range from 5% to 14%.

The program should go a considerable way toward unlocking the securitization markets, providing fresh cash to lenders to support a variety of consumer and small business loans. While the notion that bank lending all but shut down at the same time the securitization markets

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froze up was largely a myth, easier credit availability by way of the securitization channels should bring with it some degree of pickup in economic activity. Freer availability of auto loans, for example, should lead to more car buying, and increased sales of the materials used in manufacturing autos.

Initially, the facility will focus on securities backed by new auto, credit card, student and small business loans. But an expansion into other areas, including private-label residential mortgage backed securities and commercial MBS is contemplated. The Fed is showing particular concern about the commercial real estate market, with Fed chairman Ben Bernanke last week warning of a "looming crisis" because "owners of shopping malls, hotels, rental properties and many other types of buildings are unable to refinance or pay for new construction because CMBS securitization market has completely shut down."

Reportedly, Treasury Secretary Tim Geithner was deeply involved in the design of TALF, so it's not implausible to think that it could serve as a model for the toxic asset cleanup effort that he promised last month, but hasn't yet delivered on (see "Two Strikes for Tim" February 11, 2009). Obviously, such a Treasury program would not be limited to AAA-rated securities, but the basic parameters could be very similar, with federal financing and guarantees supporting private purchases. The financing would solve the problem of the lack of availability of leverage for potential speculative buyers, and the guarantee would draw a line under speculative risk. Such a program would surely enable toxic assets to find a much higher equilibrium value than they can realize today.

As much as we welcome the TALF and believe it will have salutary impacts, there are some troubling aspects of the facility's roll-out. One potential stumbling block would have been if participants were subject to the draconian compensation restrictions on TARP recipients recently enacted by Congress as part of the so-called stimulus legislation (see "On the New Bank Bonus Restrictions" February 15, 2009). That would have been a major disincentive to involvement in the program. But as it turned out, the Fed/Treasury determined that the compensation restrictions would not apply. "Given the goals of the TALF and the desire to encourage market participants to stimulate credit formation and utilize the facility, the restrictions will not be applied to TALF sponsors, underwriters and borrowers as a result of their participation in TALF," said the New York Fed's document on the program answering frequently asked questions. That might be fine as far as it goes, but under what authority are Fed and Treasury simply declaring that the restrictions don't apply? If the rationale for such treatment is based on a "desire to encourage market participants to stimulate credit formation," why would it not also apply to other programs that have the same objective? As has occurred on a number occasions during this crisis, this treatment of the compensation question is an example of the pliable interpretation of the rule of law practiced by our governing authorities. This is one important source of the uncertainty that continues to plague the markets

In its final paragraph, the Fed/Treasury announcement noted that, "increased TALF lending and other actions to stabilize the financial system have the potential to greatly expand the Federal Reserve's balance sheet." In a repeat of the statement issued last month coincident with release of Geithner's financial rescue agenda, the announcement again makes an opaque reference to legislation it will seek with Treasury to give it the tools "to manage the level of reserves while providing the funding necessary for TALF and other key credit-easing programs" (see "Treasury Won't Bail Out the Fed" February 17, 2009). At that time, we were told by a Fed official that the intent was to allow Treasury to continue issuing debt for the Fed's special financing facility without such issuance counting against the debt limit. By taking cash out of the system and putting it on deposit at the Fed, the facility acts to drain liquidity, offsetting some of the Fed's liquidity injections. But we remain highly skeptical that with its other huge borrowing needs, the

Treasury will be disposed to issuing enough debt for this facility to make much of a difference. In the final analysis, the Fed's approach to this crisis is likely to have significant inflationary consequences. But that's the price to be paid to avoid a far worse calamity.

BOTTOM LINE: The TALF program is probably the single most positive government initiative yet launched during this seemingly interminable period of credit market crisis. The Fed is offering investors a deal that's too good to refuse, to encourage purchases of asset-backed securities and unlock the securitization markets. We expect TALF to have a significantly positive payoff in credit availability, helping to begin financing a restoration of economic activity.