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Financing Facilities

Onerous Customer Agreements Undermine Investor Interest in the TALF, but TALF Trusts Offer a Creative Solution for Hedge Funds Interested in Participating

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By Jennifer Banzaca, *Hedge Fund Law Report*

The first round of the Federal Reserve Bank of New York and the United States Treasury Department's Term Asset-Backed Securities Loan Facility (TALF) program has launched to a lukewarm reception among investor-borrowers. According to a statement issued by the Federal Reserve on March 18, 2009, in its first round of funding, the TALF program received only $4.7 billion in requests for loans out of $200 billion in available loan capacity. Only 19 hedge funds applied for funding. Market participants attribute the relative lack of interest in part to resistance on the part of investors to the terms of customer agreements that investors are required to enter into with dealers.

According to lawyers who have negotiated such customer agreements, the customer agreements are more restrictive than the Master Loan and Securities Agreement (MLSA) that primary dealers must enter into with the Federal Reserve to participate in the TALF. The customer agreements are generally dealer-friendly, including unilateral set off rights that favor dealers and broad rights for dealers to inspect investors' books and records. Dealers are demanding these rights because they are not being compensated in their capacity as conduits for TALF money. "The dealers are not getting paid to be an intermediary between the Federal Reserve and the investor and they want to make sure they are not taking on any risks or liabilities. When the Master Loan and Security Agreement was circulated, most investors assumed the dealer would sign a simple agreement with the borrower. There are a lot of obligations in these agreements that were not expected by the investor community," noted Paul Watterson, a Partner with Schulte Roth & Zabel LLP.

In light of the lack of participation in the TALF and investor concerns regarding the terms of customer agreements, some primary dealers have created trusts to participate in the TALF. Under these structures, a bank sets up a trust to buy TALF-eligible securities using money borrowed from the Fed. Investors can then purchase securities or units in the trust as a way of obtaining the leverage offered by the TALF without directly participating in the program.

Market participants expect that prior to the next round of funding – for which the Fed will start accepting subscriptions on April 7, with loans to be settled on April 14 – there will be additional negotiations on the terms of the customer agreements, as well as further refinements to the trust structure being developed by banks. "The expectation is that in the next two weeks, in preparation for the April borrowing, there will be more negotiations either directly by investors

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who did not sign the customer agreement with dealers and possibly another round of major dealers negotiating with asset managers," Watterson said. "I think there will be some changes to the agreement prior to the next round of loans."

Despite the middling participation in the first round of funding, the Fed remains optimistic about the prospects for the TALF. In a statement, Fed President and Chief Executive Officer William C. Dudley said: "This is a good start for a program that we will continue to build on in the future. It is encouraging that the spreads in the areas where the program is now focused have narrowed significantly. Our goal is to get the securitization market working again."

TALF Background

Generally, the TALF offers low-cost, three-year financing to a wide range of U.S. banks and investors for the purchase of newly-issued securities backed by consumer loans. As originally established, the facility provided $200 billion in lending capacity for securities backed by student loans, auto loans, credit card loans and loans guaranteed by the Small Business Administration. In February, the Fed expanded the capacity of the program to as much as $1 trillion. See "As Prime Brokers Tighten Lending to Hedge Funds, the Federal Reserve Increases Hedge Fund Financing Capacity with Expansion of the TALF," Hedge Fund Law Report, Vol. 2, No. 7 (Feb. 19, 2009).

On March 23, 2009, as part of its announcement of the Public-Private Investment Program, the Treasury announced that it and the Fed would make non-recourse loans available to investors to fund purchases of legacy securitization assets, including certain non-agency residential mortgage-backed securities that were originally rated AAA and outstanding commercial mortgage-backed securities and asset-backed securities that are rated AAA. See "United States Treasury Department Announces Public-Private Investment Program – In Effect, Becomes the World's Largest Prime Broker," above, in this issue of the Hedge Fund Law Report.

Concerns with Customer Agreements

As the TALF is currently structured, primary dealers act as intermediaries between potential investor-borrowers and the Fed. In practice, the dealers originate loans ultimately funded by the Fed. As such, the dealers evaluate the eligibility of investor-borrowers. Potential investors must be customers of a dealer, and must execute a customer agreement authorizing the primary dealer to, among other things, act as an agent for the borrower and execute the MLSA on behalf of the borrower.

For hedge funds that are potential TALF participants, the form of customer agreement currently being used by dealers alter some of the material terms of the TALF, and render participation significantly less attractive. Since dealers are not being compensated – or, in their view, adequately compensated – for their role as intermediaries, they are asking investors to assume liabilities in the customer agreement that the Fed is not asking the dealers themselves to assume. For example, the MLSA states that borrowers are not responsible for ensuring the eligibility of collateral, but the customer agreement does impose that obligation on investors. Perhaps more importantly, one of the most attractive features of the TALF from the investor perspective is that the Fed loans are "non-recourse," meaning that if the Fed lent a hedge fund investor $93 to purchase an asset-backed security with a face value of $100, and the security lost all of its value, the Fed would not have the legal right to seek repayment from the fund; the Fed's

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only valid source of repayment would be the security itself, which would serve as collateral for the loan. This arrangement is embodied in the MLSA, but is abridged in the customer agreement. In the agreement, dealers are requiring investors to guarantee their borrowings, either explicitly, or implicitly, via a right held by the dealer to reduce any amounts it owes the investor by the amount of any loan the investor has not repaid to the dealer – including TALF loans (a so-called set-off right).

According to Hays Ellisen, a Partner at Katten Muchin Rosenman LLP, and Co-Chair of the firm's Structured Finance and Securitization Practice, Credit Crisis Solutions Group, Covered Bonds Team and Troubled Asset Relief Program Task Force, "there are particular provisions in the customer agreement that don't exactly match to the MLSA. I think there are a number of issues where the agreement doesn't seem as though it was drafted equitably on many issues, including issues involving indemnity, set-off rights, dealing with issues of amendments to the agreement, reps and warranties. It's very one-sided. On a number of points, the dealers are protecting themselves in a way that seems excessive, especially in light of the role that they're playing in the transaction. In certain cases, they're requesting things, like consent rights over the borrower's transfer of the loans or collateral, that just don't seem appropriate with respect to their role as simply an agent in the transaction."

Ellisen also explained what might be called the "de facto recourse" provision in the customer agreement, in the form of the broad and unilateral recourse right vested in dealers. "The recourse issue," he said, "one of the ways you get to that is through these broad set-off rights that the dealers have against the customers. Essentially, the customer has no right of set-off against the dealer but the dealer has a very broad right of set-off against the customer and any of its related entities. So, indirectly, you could be making the borrowers' obligations recourse because if the borrower or any of its related entities have any payments that they owe the dealer on any other obligations, this could be brought through this set-off right in the customer agreement."

Watterson also noted another wrinkle arising from dealers' potential dual role as Fed loan intermediaries and underwriters of securitizations eligible for purchase with TALF loans. "One of the big, big difficulties between the investors and the dealers is that if a bank is an underwriter on an auto loan deal and an investor wants to buy a AAA rated class with TALF financing, the investor would sign a customer agreement with the bank as a primary dealer. The investor would then subscribe to buy the AAA securities from the bank as the underwriter of that auto loan deal. The investor concern is that it would get to the loan closing date, which is also the date of the closing of the auto loan securitization, and it won't get the TALF loan. The customer agreement says that if an investor doesn't get the TALF loan, it must still buy the securities from the primary dealer's affiliated underwriter. The investor would not have agreed to buy the securitization if they weren't getting the TALF loan. The Fed reserves the right to not make loans to anyone they do not feel is appropriate. This week the Fed said that it will pre-clear borrowers and in the event the Fed later determines that it can't lend to the borrower, the Fed will make a loan to the primary dealer so that the dealer can buy the security with leverage. Investors hope this will make it possible for the dealer to say to the borrower, if you don't get the TALF loan, I won't make you buy the security."

Despite the various concerns relating to the customer agreement and the evidence of minimal participation in the first round, some remain sanguine with respect to future participation in the TALF. Victor Zimmerman, Vice Chairman of the International Funds Group at Curtis, Mallet-Prevost, Colte & Mosle LLP, suggested that in light of the opportunity presented by the TALF program for credit in a still-tight credit environment, further negotiation of the terms of customer agreements is unlikely. "I think that the demand is so great that I doubt there will be

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much negotiation over the terms of the agreement. Even though the terms of the agreement may be difficult for some to swallow, I think the opportunity for the investment through the program is something that a lot of people don't want to pass up."

TALF Trusts

Partly in response to investor dissatisfaction with the customer agreement, banks and dealers have been setting up trusts to enable investors to indirectly access the leverage provided by the TALF.

As Schulte's Watterson explained, the "customer agreement that the primary dealers have proposed for the customers to sign has been perceived badly by many investors and that agreement hasn't been fixed. With that in mind, one dealer has said that they, the dealer, will set up a trust that will be the eligible borrower and that trust will sign the customer agreement with us so investors don't have to sign the agreement they don't like."

Accessing the TALF via a trust also has other benefits not present via direct participation. One such advantage, identified by Ellisen, is the ability to assign trust interests. "In order to assign your interest in a TALF loan, you need the consent of the Fed after December 31, 2009, which some of the hedge funds don't like," Ellisen explained. "Now, if they bought a bond through the TALF certificate program, they would be able to freely trade that bond."

Ben Shoval, Managing Director at hedge fund Ambit Funding, said he likes the idea of the trust because it would clear up concerns some hedge funds have regarding additional scrutiny by the Fed or by dealers of the funds' books and records. "Now all the Fed will be able to look at is the books of the trust and the manager of the trust, which is not going to be the hedge fund. The hedge fund is going to invest in units of the trust, and the trust will be run by the primary dealers. The banks are used to the Fed looking at their books. It's a good deal for everybody."

The trust would also open the TALF program up to additional investors, Shoval suggested, because hedge funds that could only make smaller allocations could simply buy a bond from the trusts. "A significant portion of the money in the industry is in smaller funds that really weren't being targeted as potential investors in this program. Under this new structure where the banks are just going to be going out and selling units in these trusts, everybody can participate. Lots of hedge funds can buy smaller allocations of these trusts. The trusts also create a standardized product to sell to the insurance companies, pension funds and other similar investors."

Zimmerman, on the other hand, does not think the trusts are the most direct route to increasing participation in the TALF. "I think the best way to get more investors to participate is to increase the size of the program overall because right now there is a tendency on the dealers' part to just favor their clients. Somebody would have to say that the dealers would have to open it up. Some investors may like coming in through the trust better but I still think the biggest problem is that there's more demand than supply."

Importantly, the trust approach remains an imperfect means of circumventing the customer agreement because even though it relieves the investor of the burden of executing the customer agreement directly, the investor remains subject to the terms of the customer agreement indirectly because the trust itself – in which the investor owns an interest – is subject to the customer agreement. According to Watterson, the "investment would still be burdened by the agreement because the trust would be subject to all the provisions of the agreement. The trust may save investors the administrative difficulty of setting up a special purpose vehicle to be the eligible borrower and from having to sign this customer agreement since investors simply

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purchase a trust certificate, but that doesn't eliminate the burden of the customer agreement because the trust is still bound by its terms."

Similarly, Ellisen observed that the trust itself would be subject to netting of payments, which could decrease amounts distributable to trust unit holders. "If the trust signs the same form of customer agreement that the borrower would have to sign if they were otherwise getting a TALF loan, and if the trust therefore has certain financial liabilities it has to pay under that customer agreement, those liabilities would be passed through to the investors in the form of netting out of payments off the top of the waterfall. You could argue with respect to a lot of concerns that have been raised with respect to the customer agreement that these trusts really don't resolve them. It simply passes them through in the form of netting out of payments."

Additional Changes to TALF

Aside from possible changes to the customer agreement, there will be other changes to the TALF program effective in the April funding. The Federal Reserve Board announced that the set of eligible collateral for TALF loans has been expanded to include four additional categories of asset-backed securities (ABS) including ABS backed by mortgage servicing advances, ABS backed by loans or leases relating to business equipment, ABS backed by leases of vehicle fleets and ABS backed by floorplan loans. The Treasury Department's March 23, 2009 Fact Sheet of the Public-Private Investment Program did not specify whether the legacy asset-backed securities eligible for purchase with TALF loans would include the foregoing categories of securities.

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