

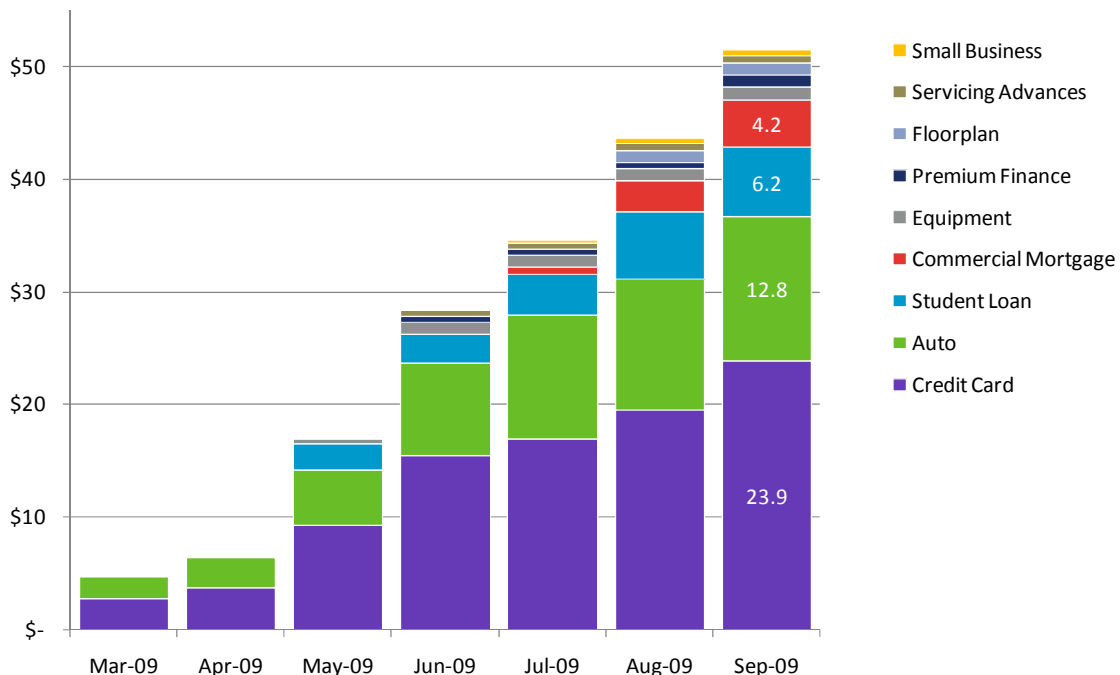
The TALF Program – Financial Market Impact and Loan Valuation Considerations

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In many ways, the turmoil in the global financial markets over the past two years has been unprecedented. Quickly and efficiently, the ubiquitous financial storm unraveled even the most basic of market functions, drying up liquidity and freezing credit for consumers and businesses. Perhaps even more unprecedented has been the response by central banks and federal agencies around the globe. In the U.S., for example, we have seen the Treasury inject capital directly into banks, the FDIC increase guarantees on bank deposits, and the Federal Reserve Board (the “Fed”) implement a raft of temporary liquidity facilities and take other measures designed to introduce stability to the financial markets.

One of the more notable efforts by the Treasury and the Fed to bolster credit markets has been the Term Asset-Backed Securities Loan Facility (TALF). TALF is designed to increase credit availability and stimulate the securitization markets by providing up to \$200 billion in loans to finance the purchase of eligible new, and certain legacy, highly rated securities backed by auto loans, credit card receivables, student loans, small business loans, and commercial mortgage loans. Since the program was launched in March 2009, there have been approximately \$51.5 billion in loans issued by the Fed to participating TALF borrowers (see, Chart I. Cumulative TALF loan issuance through September 2009).

Chart I. Cumulative TALF loan issuance through September 2009, in billions*



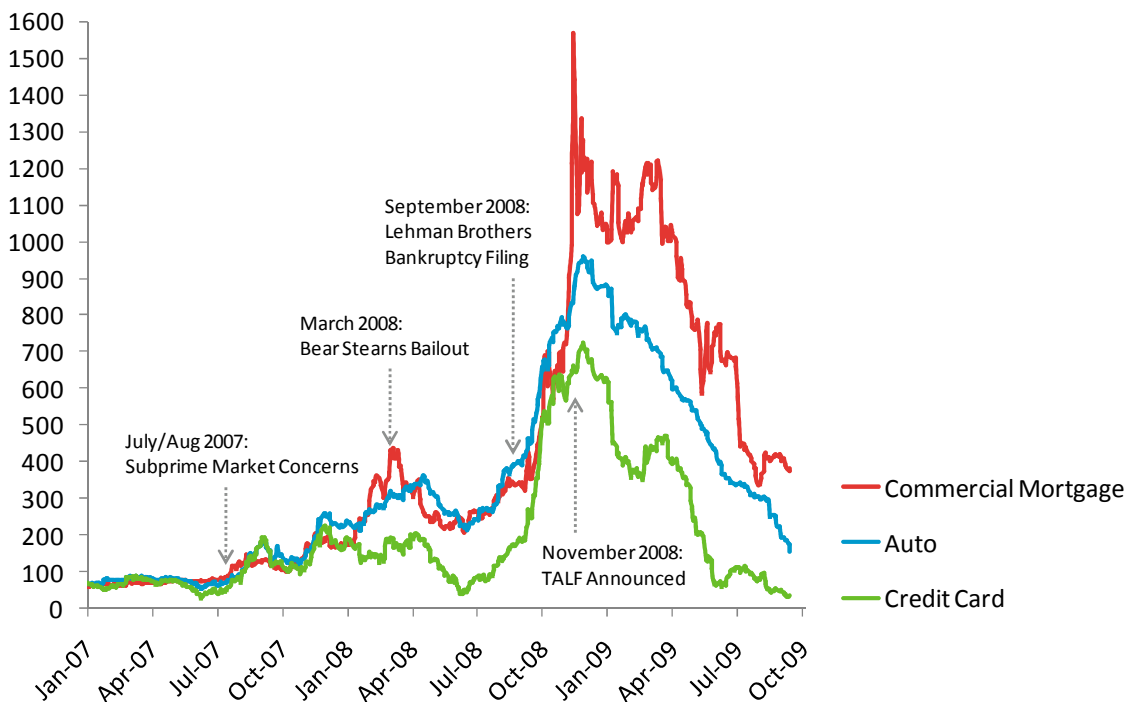
*Source: New York Federal Reserve website, <http://newyorkfed.org/markets/talf.html>

TALF Overview

TALF loans have several unique features, designed to increase liquidity in the securitization markets. TALF loans are generally recourse only to the eligible collateral securing the loan. This means that if the securities securing the loan are underperforming (e.g., if the cash flows from the ABS/CMBS collateral are not sufficient to service the cash flows due on the loan), the borrower generally can walk away from the loan and surrender the collateral with no additional liability (i.e., the economic equivalent of an American-style put option for the borrower). In practice, the option to walk away from the loan may not be exercised until the loan is near maturity, since there is always a chance that the value of the security will improve and exceed the amount of the TALF liability. In addition, the borrower is never required to re-margin or post new collateral to secure the loan, regardless of what happens to the value of the securities originally pledged as collateral.

It is no surprise that investors have been attracted to this unique opportunity to leverage AAA-rated securities with limited downside risk. The increased demand for ABS/CMBS securities can be illustrated by examining historical ABS/CMBS spreads (over comparable Treasury yields) before and after the TALF was introduced. Chart II below highlights historical spreads for a basket of AAA-rated securities backed by commercial mortgage loans, auto loans, and credit card receivables from January 2007 to October 1, 2009. In the first half of 2007, spreads hovered under 100 bps, and experienced fairly low levels of volatility. Spreads first began to widen following the subprime mortgage market concerns perpetuating in July 2007. The markedly sharp increase in spreads from September 2008 to December 2008 underscores a period of broad market uncertainty, with the major catalyst typically viewed as the Lehman Brothers bankruptcy filing. The increased volatility and a dramatic widening of these spreads suggest that investors demanded more compensation for purchasing these securities given the general market instability. Widening spreads are generally associated with downward pressure in the prices of ABS/CMBS securities, which intuitively is necessary to attract investors seeking a higher yield to compensate for increased liquidity and credit risk. Interestingly, since the announcement of the TALF program in November 2008, you can see a steady decline in spreads for ABS/CMBS securities. This suggests an increase in demand for these securities and a reduced risk premium.

Chart II. ABS/CMBS Benchmark Index Historical Spreads (in bps) over Treasuries*



*Each benchmark index represents a basket of up to 30 AAA-rated securities. Spreads determined using average life and yield data from Interactive Data for ABS/CMBS, and Treasury yield data from the U.S. Treasury Department website

Valuation of the TALF Loans

The challenges of valuing ABS/CMBS securities in the current market are also applicable to valuing TALF liabilities. Participants in the TALF program may elect to value TALF liabilities at fair value determined in accordance with Topic 820 (formerly FAS 157) Fair Value Measurements. Under Topic 820, fair value is the price that would be paid to transfer the liability in an orderly transaction at the measurements date; and the borrower will need to consider all reasonably available market inputs as well as the specific features of the TALF loan. As a result, these inputs could include the value of the underlying collateral as well as the non-recourse features of the loan.

Under the terms of the TALF loan, interest and principal cash flows from the ABS collateral are directly applied to the interest and principal payments owed under the loan. Thus, in order to value the loan, one should understand how the ABS is expected to pay down in the future, and use those same assumptions (e.g., prepayment speeds, projected cash flows, etc.) to forecast the future cash flows expected to be available to service the loan. In addition, the valuation of a TALF loan should account for the ability of the borrower to walk away from the loan. As discussed earlier, this is the economic equivalent of an American-style put option for the borrower, and can be valued, for example, using an option pricing model. The borrower also has the option to prepay the loan at any time, which may be attractive, for instance, if the loan has a fixed rate coupon and interest rates decline considerably. In sum, in valuing the TALF loan one should consider: (1) the value and assumptions of the underlying ABS, (2) the terms of the loan, (3) the value of the theoretical put option embedded in the loan, and (4) the value of the theoretical prepayment option embedded in the loan.

Summary

As illustrated in Chart II by the decline in spreads beginning in November 2008, the unique terms of the TALF program may have helped lower borrowing costs and increase investor demand for ABS/CMBS securities. This was likely a factor in the decision to extend the TALF program beyond its original termination date in December 2009 to March 2010 for newly issued eligible ABS and legacy CMBS, and to June 2010 for newly issued CMBS. While the unique program has proven beneficial to borrowers, the determination of fair value measurements for TALF liabilities can be complex and requires the borrower to consider both the value of the underlying collateral and the unique features of the loan.

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