



Using TALF For Arbitrage Opportunities in the SBA Pool Market

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The TALF program and recent revisions have given market participants plenty of opportunities to ponder. Most of these opportunities utilize AAA rated assets given that the bulk of ABS securities have no governmental agency guarantees. However, one sector, SBA adjustable rate pools, offers many benefits to an investor contemplating the use of TALF funding as the liability side of an arbitrage opportunity with a *full faith and credit asset!*

Potential Benefits:

- **Funding source of up to 3 Years at Fed Funds target rate + 75bps.** This is particularly attractive given the events of the last couple of years since funding sources are now scarce or, when available, more expensive and subject to being called at much shorter intervals.
- **Funding source with minimized basis risk.** SBA pools are generally benchmarked vs. PRIME rate, which has enjoyed a 99% correlation (r^2) to Fed Funds over the last 15 years. This funding rate is equivalent to a nominal rate of PRIME-2.25 (average spread of PRIME-FF over last 15 years is 299.9bps).
- **Asset with no credit risk.** Other assets eligible for TALF funding have different degrees of credit risk. The SBA pools are full faith and credit and also carry a 0% risk weight for depository institutions.
- **Limited asset/liability pricing mismatch.** TALF funding will reprice monthly where SBA pools are either monthly or quarterly reset. Even with a quarterly reset asset vs. a monthly liability, the inherent mismatch is minimized when the indices themselves are considered. In other words, Fed Funds will generally move with PRIME, unlike LIBOR which anticipates changes. (Fed Funds and PRIME are *administered* rates vs. the *market* rate of LIBOR).
- **Asset at historically cheap levels.** SBA pool prices are currently at ten year lows. Effective margins (BEEM) relative to PRIME are as generous as seen in years. These full faith and credit assets can currently be purchased with yields equivalent to PRIME – 1.75% or higher depending on the investor's premium tolerance. This phenomenon is beginning to correct and likely will not last long. (One year ago, these same assets were trading in a range of PRIME-2.625% to PRIME-2.375%.)
- **Asset with excellent performance expectations.** SBA pools have seen a dramatic decline in prepayment speeds vs. peak speeds observed

several years ago. Moreover, future prepayments are expected to remain muted given the lack of refinancing opportunities for small business borrowers in the near term.

The following is an example of using the TALF funding for an SBA Pool. First is additional detail on the asset side of the example transaction.

Description:

SBA Pool #:	508611	Issue Date:	01/01/2009
Coupon:	P-.125%	Legal Maturity:	12/25/2019
Pool Size:	\$20,225,957	Loan Count:	48
Reset Frequency:	Quarterly	Cusip:	83164KR88
Price:	\$104.250	Settlement:	03/30/2009

Historic Prepayments in CPR:

	<u>1 Month</u>	<u>3 Month</u>	<u>2008</u>	<u>LIFE</u>
Specified Pool, SBA 508611	0.0%	n/a	n/a	n/a
All '08 Origination 8-11 Yr WAM	9.4%	8.2%	6.3%	7.5%
All 8-11 Year WAM	10.0%	9.9%	12.1%	4.7%

Scenario Analysis in CPR for SBA Pool 508611 (PRIME = 3.25%):

<u>Prepayment Scenario</u>	<u>10%</u>	<u>12%</u>	<u>14%</u>	<u>16%</u>	<u>CSI</u>
Bond Equivalent Yield	1.91%	1.83%	1.75%	1.67%	1.81%
BEEM relative to Prime	-134	-142	-150	-158	-144
Index Duration	0.2	0.19	0.19	0.19	0.19
Cashflow Average Life	4.07	3.82	3.58	3.37	3.74

The funding side, which is TALF, is fairly straight forward at Fed Funds target rate + 75 basis points or currently 1.00% resetting on a monthly basis. The anticipated carry for this transaction will depend on the particular prepayment expectation utilized. The TALF itself is using 14% CPR in order to determine average lives when computing the haircut to be used. This also conforms to the generic prepayment speeds utilized by many SBA pool assemblers. However, current prepayments are considerably slower than this with most recent prepayments at single digit CPR speeds and should remain muted for the next twelve to eighteen months (please contact us for complete prepayment analysis).

Using the “generic” 14% CPR speed, this example transaction would produce approximately 75 basis points of spread seen as follows:

	<u>Yield/Rate</u>	<u>Spread to PRIME</u>	<u>Spread to Fed Funds</u>
Asset (SBA Pool)	1.75%	-1.50%	+1.50%
Liability (TALF)	1.00%	-2.25%	+0.75%
"Carry"	0.75%	0.75%	+0.75%

This positive carry or arbitrage could potentially be even greater if prepayment speeds remain subdued and certainly, given our outlook, this could be the case for a substantial portion of the TALF arrangement. (For example, a 10% CPR would result in an increased carry to 91 basis points of spread.)

While cliché, the window of opportunity for this transaction will not last long – at least not at the type of levels currently available. The SBA pool sector is the only full faith and credit asset class eligible for this version of TALF and

pricing is already beginning to firm up. For additional information on this program please see the following resources:

“Term Asset Backed Securities Lending Facility” Coastal Securities
03/03/2009

<http://www.newyorkfed.org/markets/talf.html>