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TALF 2.0 Overview

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On March 23, 2020, the Federal Reserve and Treasury Department announced the Term Asset-Backed Securities Loan Facility (TALF)[1]. Similar to the 2009 TALF program, TALF 2.0 is designed to encourage private investments in asset backed securities (ABS) by providing federal government loans to investors through the New York Federal Reserve ("The Fed"). The TALF program of 2009 was one of the US Government's responses to the Global Financial Crisis, and it was successful in stabilizing capital markets and generating returns for investors in the high teens or more, depending on when investments were initiated.

The TALF 2.0 program gives investors exposure to secured, primarily triple-A rated, securitized investments with three-year terms and utilizes leverage provided by the Fed. The main appeal of the program is that Investors can borrow at a very low rate and use the proceeds to purchase assets at a potentially higher yield, with far less downside risk than is normally associated with leverage.

[1] Source: https://www.federalreserve.gov/monetarypolicy/talf.htm .

How does the TALF 2.0 program work?

The Fed and US Treasury are making up to $100 billion in capital available with the intention to loan money to US and Non-US qualified Institutional and Individual investors at financing rates in the range of approximately 1.3-1.7% (depending on the asset type and the underlying variable reference rate) to finance the purchase of TALF-eligible ABS securities. They will be accepting the purchased securities as collateral for the loan. Loans in the TALF program are not cross collateralized. Securities must be issued during the "TALF window" which is scheduled to begin in mid-June 2020 and close September 30, 2020.

The TALF 2.0 securities are generally shorter duration relative to typical core fixed income allocations, which are often benchmarked to the Bloomberg Barclay's Aggregate Index[2]. The underlying securities are triple-A rated and they are securitized, meaning the specific underlying assets (e.g., student and credit card loans) serve as collateral. It is worth noting that ABS comprises only a small portion (0.4%) of the Aggregate index.

[2] The duration of the ABS segment of the index was 2.1 years versus 6.0 years for the overall index as of June 2, 2020.

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The financing rates vary by asset type and are based off of various reference rates such as the overnight index swap (OIS) rate or the secured overnight financing rate (SOFR) that corresponds to the length of the average life of the specific loan. For example, many of the ABS security types will use financing rates of either OIS + 125 basis points or SOFR + 150 basis points.

Currently, eligible ABS include newly issued, USD denominated, and high quality AAA-rated:

- Consumer ABS (auto, student, credit card)
- CLOs
- CMBS (conduit, legacy)
- SBA-guaranteed small business loans

The underlying loans have a maximum 3-year term and are "non-recourse" to borrowers. The non-recourse term means that if the securities become impaired and the haircut amount (explained below) is insufficient to cover the loss, the Federal Reserve cannot seize other assets of the investor beyond that initial haircut amount. The term of each underlying loan will match the maturity date of each respective security.

In addition, financing is non-mark-to-market. This is favorable for investors as it means they will not need to keep capital available to meet margin calls. The loans are pre-payable at the borrower's option, partially or in whole, but substitution of collateral during the term of the loan generally will not be allowed.

What does TALF 2.0 not include?

For now, TALF 2.0 does not cover corporate bonds, residential mortgage-backed securities ("RMBS"), certain commercial mortgage-backed securities ("CMBS"), and unsecured consumer ABS. These represent large structured credit sectors[3] that will likely be disparately impacted by the economic slowdown. As such, there may also be future programs launched by the Fed/Treasury to provide additional support for credit market assets in which the current narrowly constructed TALF mandate may not be able to participate.

[3] The Credit and Securitized sectors comprised 29.8% and 27.2%, respectively, of the Bloomberg Barclays Aggregate as of June 2, 2020.

How does the investment work?

Investors may benefit from the yield differential, if ABS yields are higher than the borrowing rate, as well as from leverage. The Federal Reserve will lend investors an amount equal to the market value of the ABS, less a haircut of around 10%. The amount of the haircut depends on the underlying asset (there is a range of 5-22%).[4] In general, the Fed expects the investors to put up less for what the Fed perceives as lower risk investments and more for perceived higher risk investments.

[4] The schedule with specific haircuts per security type can be found at https://www.federalreserve.gov/monetarypolicy/talf.htm.

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By loaning a substantial portion of the purchase price of the asset and accepting the security itself as collateral in the case of default, the program attempts to subsidize and de-risk the purchase of new issue ABS securities. Investments in a TALF fund are marked-to-market and can trade only during the TALF window (i.e., until September 30, 2020). After the TALF window closes, the investor/fund will hold the securities until maturity and thus the investment becomes "buy and hold" at that point. Valuations of the TALF securities would then be determined by standard valuation methods for assets in the ABS market trading outside of the TALF program (i.e., they will be marked to market based on non-TALF security trading).

Mechanics of the loan structure

The following hypothetical example[5] (Exhibit 1) is for illustrative purposes to help frame the mechanics of the loan. It is impossible to predict the actual outcome of the program or the underlying investments that will come to the new issue market. Meketa is not forecasting returns but numbers need to be used to demonstrate the mechanics of the loan and its potential impact on the investment. This example assumes a 12% gross return based on the assumption that spreads moderately correct during the life of the program.

[5] Hypothetical cash flow example based on terms from the Federal Reserve. The example assumes (1) the Fed provides 90% of the loan amount (i.e. 10% haircut); (2) LIBOR is 100 basis points; (3) the ABS securities yield LIBOR plus 200 basis points; and (4) the loan rate is LIBOR plus 100 basis points.

If spreads return to pre-COVID-19 levels, the example results in returns in the range of high single digits. In the example below, if the ABS market improved and spreads on new issues narrowed to pay LIBOR + 150 basis points rather than 200 basis points, income would be just $2.5 and gross return would decrease to 7% annualized.

Investors must consider the total duration of the portfolio when allocating from core to a vehicle like the TALF vehicles.

In contrast, if spreads continue to be dislocated during the program, there is the potential for higher yielding new issues coming to market, which could potentially drive mid-teens returns. In the example below, if new issue spreads widened to pay LIBOR + 250 basis points rather than 200 basis points, net profit would increase to $3.5 and gross return would be 17% annualized.

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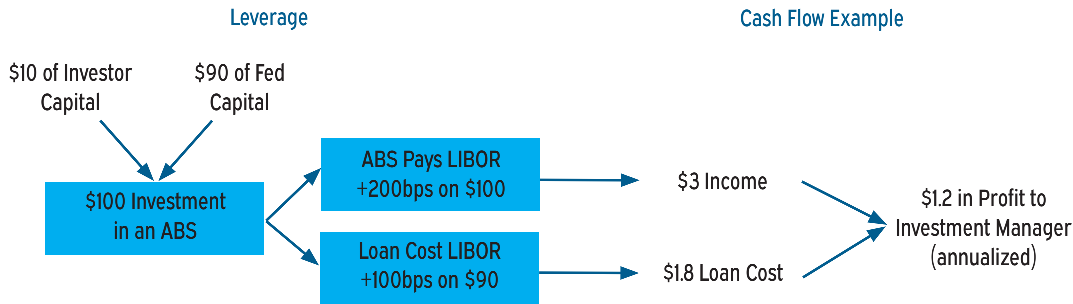
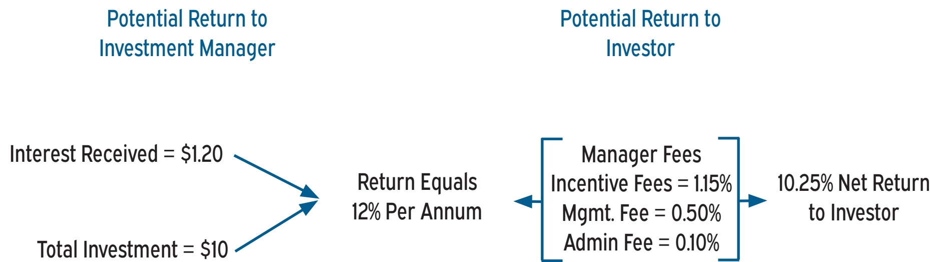
EXHIBIT 1





Implementation

This opportunity requires use of a professional money manager who has been specially designated by the New York Fed for their role in support of the TALF program.

Vehicles being established by several investment managers vary widely with various structures, styles, fees, minimum investments, liquidity terms, leverage terms, etc. Some are offering a dedicated TALF-only strategy while others are incorporating TALF investments into a recovery or opportunity strategy that focuses on a wider swath of dislocated fixed income assets.

Most managers are offering funds with fee structures that combine an annual management fee in the range of 25-75 basis points on committed capital only, along with a performance incentive fee of 10-20% participation over a hard hurdle rate in the range of 5-8%. Some of these fees may be negotiable. Investors must also pay a 10 basis point administrative fee to the Fed.

In addition to the leverage that the Fed provides, there are various levels of leverage being offered by different investment managers at the portfolio level to further enhance returns. At the time of this writing, few managers are intending to add to leverage beyond the Fed borrowing; however, some managers may have the ability to consider it if the terms of their fund allows for it.

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Risk and concerns

Investors may not be comfortable with committing capital when there is still so much economic uncertainty. However, the TALF program introduced during the GFC serves as a precedent for such a program working successfully. Still, return expectations are not as attractive as TALF 1.0.

Another concern for some investors is illiquidity, since the participating managers require a lockup of 3 or more years for TALF funds. Given that leverage is a main driver of the opportunity set, investors should be aware of the potential level of leverage to be borrowed from the Fed and the potential for some managers to lever the fund further at the portfolio level. Default risk in fixed income investments is always a consideration. For TALF 2.0, that risk is largely mitigated by the requirement that all investments be made in triple-A rated securities. Of note, the TALF 1.0 program experienced no defaults.

> While a TALF 2.0 investment may have many characteristics of an investment grade core allocation, its use of leverage, backing by the Fed, and concentration in the ABS sector could lead to a more nuanced risk-return profile.

The opportunity set becomes significantly less attractive as spreads narrow. Some spreads on the most attractive assets with the lowest haircuts laid out by the Fed, have already rallied to levels where the spread is narrower than the loan rate and therefore are no longer attractive. In the event that spreads tighten quickly, the opportunity is less compelling and managers may not deploy all capital or may exit quickly. This could also result in potential capacity limitations such that managers may not be able to put the committed funds towards good opportunities.

Another important consideration is the duration impact of the additional ABS securities on the overall portfolio. TALF and ABS assets are shorter duration than typical Core Fixed Income portfolios benchmarked to the Aggregate Index. Investors must consider the total duration of the portfolio when allocating from core to a vehicle like the TALF vehicles.

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ABS investments in the TALF fund are marked-to-market and trade only during the TALF window (i.e., until September 30, 2020). After the Fed window closes, the investor/fund will hold the securities until maturity but the investments will still be marked-to-market based on non-TALF securities trading.

Summary

TALF 2.0 is an opportunistic fixed income investment made available by the Fed to assist with the Government's COVID-19 stimulus efforts. The Fed is granting designated money managers access to relatively inexpensive Fed-backed leverage in order to purchase a pre-approved list of highly-rated ABS investments. While a TALF 2.0 investment may have many characteristics of an investment grade core allocation, its use of leverage, backing by the Fed, and concentration in the ABS sector could lead to a more nuanced risk-return profile.

The TALF 2.0 program allows investment managers to borrow at a very low rate and use the proceeds to purchase assets at a potentially higher yield. Additionally, given that the assets are higher quality than the typical core fixed income benchmark and that the source of the leverage is the Fed, the risk profile remains reasonable despite the inherent risk of leverage. This could lead to the opportunity for potentially higher returns without a substantial increase in risk.

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Appendix — Definitions

ABS (Asset Backed Securities): a bond or note collateralized by (backed by) a pool of assets, such as loans, leases, credit card debt, royalties, or receivables.

CLO (collateralized loan obligation): a single security backed by a pool of business loans. CLOs purchase a diverse pool of senior secured bank loans made to businesses that are rated below investment grade. The bulk of CLOs' underlying collateral pool is comprised of first-lien senior-secured bank loans, which rank first in priority of payment in the borrower's capital structure in the event of bankruptcy, ahead of unsecured debt. The CLO is actively managed by a CLO investment manager.

CMBS (commercial mortgage-backed securities): a type of mortgage-backed security backed by commercial mortgages rather than residential real estate. A conduit CMBS is a pool of commercial real estate loans that is sliced up and sold out to investors in tranches. Legacy CMBS are bonds issued prior to 2009 when the industry's underwriting process of the underlying mortgages became more conservative.

OIS (overnight index swap): financial contract between two parties that agree to exchange a payment at the end of the contract based on the difference between a fixed rate and the overnight index rate. The OIS rate is the average interest rate that a bank can secure for borrowing overnight funds. It is commonly used to price asset backed securities.

RMBS (residential mortgage-backed securities): debt-based security (similar to a bond), backed by the interest paid on loans for residences.

SBA (Small Business Administration): U.S. government agency that provides support to entrepreneurs and small business owners. SBA loans are made through banks, credit unions and other lenders who partner with the SBA. The SBA provides a government-backed guarantee on part of the loan.

SOFR (secured overnight financing rate): a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities. It is an influential interest rate that banks use to price derivatives and loans.

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