TAKING STOCK: DOES TALF PRESENT AN INVESTMENT OPPORTUNITY?

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The Federal Reserve is offering loans at very generous terms to investors to shore up demand for highly-rated asset-backed securities at a time of heightened uncertainty around the economic fallout from the coronavirus pandemic.

The central bank's offering of inexpensive, nonrecourse leverage adds luster to a usually dull part of this market by enhancing its return potential. The Fed's lending program, dubbed the Term Asset-Backed Securities Loan Facility, or TALF for short, allows qualified investors, including asset managers, banks and pension funds, to make large investments in AAA-rated asset-backed debt—collateralized securities with typically paltry returns because of their high credit ratings—by using only a fraction of their own capital while deploying the leverage provided by the Fed to amplify gains.

This latest incarnation of TALF—the program was initially used by the Fed in 2009 to combat the financial crisis—is aimed at reinvigorating the market for asset-backed securities, ABS for short, collateralized by auto loans, student and other consumer debt, and loans extended by the Small Businesses Administration. Launched in partnership with the Treasury, TALF will help facilitate the issuance of highly-rated ABS from March 23 through September (unless extended by the Fed Board of Governors). The leverage will not include margin calls (that spooked the markets in March) and is backed by the United States government.

At NEPC, we have held several calls with asset managers to discuss the potential investment opportunity presented by TALF. Limited partners should be prepared to act swiftly when an opportunity presents itself because of the short lifespan of the program. We expect investment vehicles will be set up as shorter-dated drawdown funds, like the fund structures used by strategies pursuing opportunistic credit, private debt and private equity.

TALF made its first appearance in November 2008, at the peak of the financial crisis, and was launched in March 2009. Eligible assets were initially limited to auto loans, student debt, credit-card borrowings, and loans made by the Small Business Administration. It was subsequently expanded to include equipment loans and residential mortgage-backed securities, and then its scope widened further with the addition of commercial mortgage-backed securities. In contrast, the current iteration of TALF includes all these types of collateralized debt from the get-go. We are still waiting on some of the details, for instance, the haircut, or the amount of equity investors must contribute as a first-loss position; the Fed has indicated that it will be similar to the schedule followed in the financial crisis.

To be sure, while TALF helped boost the return profile of highly-rated asset-backed securities on a risk-adjusted basis, returns during the financial crisis fell short of some investors' expectations. To that end, the timelines of spread tightening and defaults, and the performance of the individual debt issues will determine the success of TALF this time around.

As always, it is important for prospective investors to consider the risks related to leverage, extended maturities, prepayment and credit worthiness despite the extremely attractive loan terms under TALF. Additionally, the Fed earmarked up to $200 billion for TALF in 2009 but ultimately deployed only around $71.1 billion. Currently, the Fed has earmarked up to $100 billion for TALF. Like last time, there is no guarantee all the capital will be put to work. Prospective limited partners should be diligent in their manager selection to ensure that their committed capital is ultimately invested.

At NEPC, we will continue our conversations with asset managers over the coming weeks and, if appropriate, determine the best course of action for interested clients.

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