RVK Market Update
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Executive Summary

Written By:

RVK, Inc.

The recent establishment of the second Term Asset-Backed Securities Loan Facility (TALF) presents credit investors with a range of new and potentially compelling opportunities through the Federal Reserve's provision of extremely low -cost financing for investments in a select group of high quality asset-backed securities. Given the TALF's recently announced parameters, it appears that qualified strategies focused on these assets have the potential to act both as a return engine and, in some cases, a defensive element for many diversified credit portfolios. However, any investors potentially interested in participating in this opportunity should be aware of both the basic mechanics of the program and a number of potential risks present at both the investment and fund levels. Most notably, the high leverage required to achieve most investors' desired returns, expected limitations on access to the TALF, and the relative illiquidity of most underlying assets encompassed by the TALF program could lead to material problems for the TALF-focused strategies that are captained by inexperienced teams or incorrectly designed.

TALF Program Purpose and Structure

The second Term Asset-Backed Securities Loan Facility or "TALF 2.0" is a facility that was established by the Federal Reserve on March 23, 2020 to support ongoing access to credit for US consumers and businesses during the current economic disruption. The facility is intended to enable the issuance and purchase of a range of asset-backed securities (ABS). Essentially, the TALF will finance the expanded purchase of these securities through low-cost loans to qualifying investors, making investment in these securities potentially more profitable through the use of the TALF's low-cost leverage. The resulting increase in expected investor demand for qualifying ABS securities is, in turn, expected to enable a higher volume of their issuance, and so a higher volume of lending for the loan types that qualify as collateral for the TALF program—predominantly consumer loans and loans to small businesses. The resulting expansion of credit to consumer and small businesses is intended to help stabilize these two groups by more completely meeting their credit needs. In addition, the inclusion of several types of recently dislocated structured credit securities such as commercial mortgage backed securities (CMBS) and collateralized loan obligations (CLOs) is expected to lend stability to loan issuance and pricing in these parts of the US credit market.

The TALF loans will be made by the Federal Reserve Bank of New York through a special purpose vehicle (SPV), in which the US Department of the Treasury will make an equity investment. As of the time of this writing, an initial total of up to $100 billion of loans could be made available to investors. Interest rates will vary by asset type, but for the 2020 TALF program, the interest rate charged to borrowers using the TALF is expected to be as follows:

- CLOs – 150 basis points (bps) over the 30-day average secured overnight financing rate (SOFR);
- SBA Pool Certificates (7(a) loans) – top of federal funds target range plus 75 bps;

- SBA Development Company Participation Certificates (504 loans) – 75 bps over 3-year fed funds overnight index swap (OIS) rate; and
- Eligible ABS without government guarantee –
    i. Securities with weighted average life (WAL) less than 2 years - 125 bps over the 2-year OIS;
    ii. Securities with WAL of 2 years or greater – 125 bps over the 3-year OIS.

Loans are expected to have a three-year term.

In exchange for access to the TALF's low cost financing, investors will pledge a combination of the asset-backed securities they purchase and a limited amount of their own funds as collateral. The amount of the required borrower-provided cash portion of the investment, or "haircut," is what determines the amount of leverage that the TALF's investors are able to achieve. For example, a 10% haircut (haircuts in the TALF program are typically expected to range from 5% to 22% depending on collateral type and maturity) would allow for a borrower to invest a total of 10X their available capital in qualifying asset-backed securities. If investors are able to earn a 1-2% spread on their investments in qualifying asset-backed securities, this could translate into a total gross return of around 13-23% (see Exhibit 2 for full details). The TALF loans are also non-recourse to their borrowers, meaning that the TALF loans are secured only by the asset-backed securities purchased with the TALF financing and the cash contributed by borrowers as collateral. As such, the cash portion of required TALF collateral represents the maximum loss that a TALF borrower would face in the event that the collateral behind the asset-backed securities they purchased was to default, even given default and loss rates of 100%.

The TALF program announced on March 23rd represents the second iteration of TALF activity. The first TALF program was launched by the Federal Reserve during the Great Financial Crisis, and operated from March of 2009 through June of 2010, generating a total of over 2,000 loans collateralized by a broad range of asset-backed securities. As noted, for the second iteration of the program, the Federal Reserve has announced its intention to initially make up to $100 billion of loans available to ABS investors through the TALF, with potential for further expansion of the program to encompass either a higher volume of loans or a broader range of collateral types at a later time if needed.

As noted earlier, at its core the TALF program represents the extension of a series of low-cost, non-recourse loans to investors in asset-backed securities holding suitable collateral. In order to be eligible for the program at this time, collateral must be:

- US dollar denominated cash asset-backed securities;
- Non-synthetic exposure (no derivatives or similar non-cash financial instruments);
- Issued on or after March 23rd, with the exception of CMBS;
- CMBS issued on or after March 23, 2020 is not eligible;
- For CMBS, the underlying credit exposures must be to real property located in the U.S. or one of its territories;
- Recipient of an investment grade rating or the highest available category in quality from at least two eligible nationally recognized statistical rating organizations ("NRSOs");
- Have been predominantly originated by US companies at the underlying loan level; and
- Have a US company as its issuer.

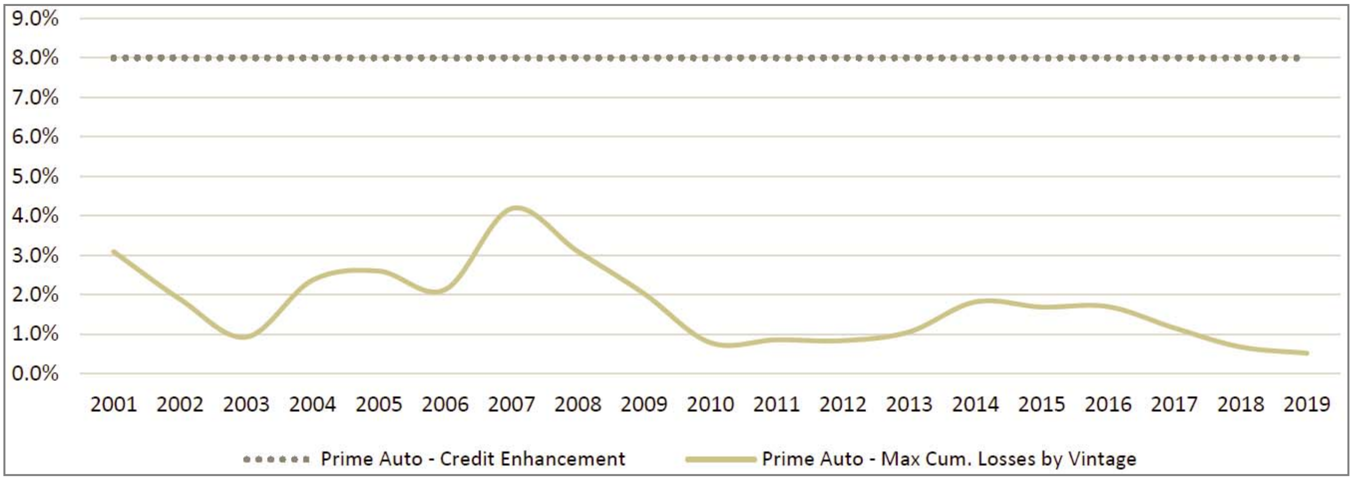
Although the facility could potentially allow for the creation of a very broad range of asset-backed securities, at the time of this writing, the securities in which TALF-oriented strategies invest are typically expected to be backed by the following types of assets:

- Auto Loans and Leases;
- Credit Card Receivables (Both Consumer and Corporate);
- Student Loans;
- Loans to Small Businesses that are guaranteed by the Small Business Administration;
- Equipment Loans and Leases;
- Floorplan loans;
- Insurance Premium-Backed Loans;
- Certain small business loans that are guaranteed by the Small Business Administration;
- Leveraged Corporate Loans; or
- Commercial Mortgages.

As such, the borrower risk to which the TALF strategies are exposed is likely to be heavily tilted toward consumers and small businesses, especially compared to the exposure incurred by more traditional fixed income strategies, which focus on large corporate bonds. This presents the potential for the TALF fund investors to diversify away from the large-sized corporate credit risk that dominates most institutional fixed income portfolios, which could be attractive to some investors during a time when defaults across large corporate borrowers is expected to rise due to patterns of high corporate borrower leverage and overstated corporate earnings. However, it should be noted that smaller businesses and non-corporate borrowers can be more vulnerable to default than large corporate entities during many types of economic disruption. Given this, we do not necessarily view the small business and consumer focus of the underlying collateral to be a protective element in and of itself—instead, we believe any exceptional protection against losses enjoyed by the TALF funds will be driven primarily by the levels of overcollateralization associated with these securities, and the high credit quality standards required of collateral approved for use in the TALF facility.

It is important to note that the level of overcollateralization required for asset-backed securities to achieve the extremely high grade ratings required by the TALF program provides investors with some protections against security-level losses even in the event of material delinquencies, defaults, or impairments in value across the underlying collateral backing these securities. This has resulted in an almost complete absence of historical defaults during even stressed periods such as the financial crisis of 2008-2010. Specifically, assuming historical loss-given-default rates across qualifying collateral, in most cases a cumulative default rate of 20% or higher would be required to impair the AAA asset-backed securities associated with the program. For securitizations backed by higher risk collateral such as subprime auto loans, the level of subordination protecting AAA tranches is often substantial enough that it would likely take cumulative default rates of up to 60% of underlying collateral to impair them. In our view, this level of overcollateralization is necessary to protect the TALF investors from outsized losses, given the program's core function as a supplier of low-cost leverage and the correspondingly high amount of leverage that most TALF investors will likely use. For ease of reference, Exhibit 1 pictures the historical loss rates and credit enhancement associated with AAA prime auto securities—another category that we expect to make up a meaningful part of the TALF securities.

Exhibit 1 – Prime Auto AAA Collateral Losses vs. Credit Enhancement



Source: JP Morgan, Hildene Capital Management

Illustration of TALF Investment Mechanics

To further illustrate the basic parameters and different components of expected returns for TALF-focused investments, Exhibit 2 outlines the basic cash flows that would be associated with a hypothetical investment in high quality asset-backed securities with access to the TALF financing. It should be noted that the exact parameters of this example are likely to differ slightly from the true range of rates and yields to which any specific investment would be subject, as both will be determined by the specific asset-backed securities used as collateral and the exact levels of applicable risk-free rates at any given point in time. However, we believe this example to fall within the general "ballpark" of what would be realistic for most TALF investments, given the parameters recently announced by the Federal Reserve. Note that, due to the high levels of leverage used in these types of investments, even small differences in the spread of asset-backed securities over their corresponding risk-free rates at the time of purchase are likely to drive large differences in expected return. For example, an increase in spread over the two-year LIBOR rate from 2% to 3% for the securities in the investment example on the following page would change the expected return of this hypothetical investment from 13% to 23%.

Exhibit 2 – Hypothetical TALF Investment

Assumptions	
Two Year Overnight Indexed Swap Rate (OIS)	0.10%
Two Year LIBOR Rate	0.50%
TALF Loan Interest Rate (OIS Rate + 1.25%)	1.35%
AAA ABS Yield (LIBOR Rate + 2%)	2.50%
Haircut	10%
Investment Example	
Investment Size	$100
Total ABS Purchased	$100
Borrower Capital Provided	$10
TALF Facility Capital Invested	$90
Performance Calculation	
Interest Expense	$1.22
ABS Investment Income	$2.50
Total Investment Profit	$1.29
Expected Rate of Return (Profit/Borrower Capital)	**13%**

Source: RVK, Federal Reserve. Presented for illustrative purposes only.

TALF Opportunities for Institutional Investors

For institutional investors seeking the type of return profile derived from levered exposure to high quality (AAA) asset backed securities, a number of investment options are available. These include both partial exposure to the TALF related investments through multi-strategy funds (typically either private credit, opportunistic fixed income, or hedge funds), or dedicated exposure through a fund with the explicit, stated intent to invest most or all of its capital in qualifying AAA asset-backed securities with financing from the TALF program. For both types of strategies, we strongly recommend that investors select a strategy with a level of liquidity that roughly matches the liquidity of the underlying asset-backed securities that the strategy intends to purchase—typically 2-5 years. As with other investment types, a mismatch between the liquidity offered to a strategy's investor base and the liquidity of its underlying assets can potentially lead to forced selling of strategy assets at a discount. For highly levered strategies such as those intending to make use of the TALF, the impact on returns of even moderate discounts to underlying asset prices can be especially severe.

In general, we also recommend that investors gain exposure to strategies and teams that have, if possible, participated in the 2009-2010 TALF facility, and so gained familiarity with its mechanics and associated counterparties. At an absolute minimum, we believe that investment teams should be extremely familiar with the issuance and trading of high-quality asset-backed securities. Although broad-based interest in participating in the 2020 TALF program appears to be surfacing across much of the investment industry, we believe that some less experienced firms and teams may not be sufficiently qualified to make these types of investments, particularly from an operational or risk control perspective. This has the potential to either erode returns through asset management, underwriting, back office or trading errors, or result in a lack of expected access to the TALF and underinvested capital.

That being said, because the rate of default across most AAA asset-backed securities has been either low or negligible during most time periods (see Exhibit 1) and their pricing is typically relatively uniform, we believe that the primary drivers of return for these strategy types will be:

- Access to the TALF funding at the manager's desired volume (which may be determined by manager experience and investment team networks);
- Appropriate and thorough risk control procedures;
- A lack of operational errors; and
- The fees which strategies charge their investors.

As such, the profile of a dedicated TALF strategy is closer to an asset allocation or "beta trade" than that of most strategies focused on higher-risk, higher-yielding assets, where returns can often be driven primarily through credit underwriting and selection.

Investment Profile and Considerations

Most TALF-focused strategies are targeting expected net annualized returns of between 10% and 20%, virtually all of which is expected to be derived from the levered spread between the interest rate of TALF-provided financing and the yields of targeted asset-backed securities. As noted, dedicated TALF strategies are typically expected to be characterized by low levels of underlying borrower default, high levels of leverage, and moderate (two to five year) levels of illiquidity. As such, investors may choose to bucket any dedicated TALF strategies in which they participate as non-core or opportunistic fixed income or, in some cases, as part of a dedicated private credit or alternative credit allocation. However, the high quality of underlying AAA securities is likely to result in a security-level risk profile much closer to that of high quality investment grade bonds than that of high yield bonds.

For ease of reference, we have included some key dimensions in Exhibit 3 that we believe are of a typical TALF-focused strategy compared to those of a typical investment grade bond focused strategy—a more common fixed income investment type that roughly matches the level of credit quality expected of underlying TALF securities, as noted previously.

Exhibit 3 – TALF Fund vs Investment Grade Bond Fund, Key Dimensions

Dimension	Dedicated TALF Fund	Investment Grade Bond Fund
Expected Net Annualized Return	10-20%	10%
Management Fee	0-1.25%	0.45%
Incentive Fee	0-20% with Hurdle Rate	None
Liquidity	3-5 Year Lockup of Capital	Monthly
Interest Rate Risk	Low to Moderate	Moderate
Credit Risk (Defaults/Downgrades)	Low (AAA)	Low (AAA) to Moderate (BBB)
Reinvestment Risk	Low	Moderate
Structural Risk	Higher (High Leverage)	Moderate (Sharp Outflows)

Source: RVK.

Investor Appropriateness

At its core, the key advantage that the TALF program offers investors is the ability to lever investment in the debt of high quality assets at an extremely low cost. As such, TALF focused strategies and opportunities typically involve high amounts of leverage, and are usually only appropriate for clients with tolerance for high absolute leverage levels, such as would also be found in many types of fixed income relative value or quantitative hedge fund strategies. As previously noted, many TALF funds are also illiquid, due to the nature of their underlying holdings and the potential difficulties involved with unwinding such a highly levered trade over a short period of time in certain market environments. Given this, they are most appropriate for clients with long-term time horizons, and investors that will not require the returns generated by these strategies to meet any near-term cash needs.

Given the relative complexity and temporary nature of the TALF program compared to more classic fixed income strategies, the TALF may also be more appropriate for institutions where decision-makers have investment industry experience and/or tolerance of a more substantive “learning curve,” given the amount of background research that will likely be necessary to gain comfort with this investment profile. In these cases, we hope this memo has provided a solid start!

As always, RVK would be happy to answer questions or provide more information for any clients that choose to explore this opportunity further, from either an investment or educational perspective.

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RVK

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[1] Between July and October 2018, Greenwich Associates conducted interviews with 1,128 senior professionals at 924 of the largest tax-exempt funds in the US–including corporate and union funds, public funds, endowments and foundations, insurance general accounts, and healthcare organizations –with either pension or investment pool assets greater than $150 million. Study participants were asked to provide quantitative and qualitative evaluations of their asset managers and investment consultants, including qualitative assessments of those firms soliciting their business and detailed information on important market trends. RVK is one of three firms recognized in the large investment consultant category. The ratings may not be representative of any one client's experience with RVK; rather, they are representative of those clients that chose to participate in the survey. The results are not indicative of RVK's future performance. For more information, and to read the Greenwich article, please refer to the following URL: https://www.rvkinc.com/about/about.php.