TALF 2.0: Opportunity Knocks but Only for a Short Time

TALF, a market intervention program deployed during the 2008 financial crisis to keep loans flowing to businesses, was recently revived by the Fed. Opportunity abounds for credit managers, but only for a limited time.

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Among the flurry of recent US government assistance programs and policy reactions to the COVID-19 pandemic, on March 23, the Federal Reserve (the Fed) dusted off a previously successful market intervention program in the form of the Term Asset-Backed Securities Loan Facility (TALF). The latest iteration of the program (what we call TALF 2.0) will be of specific interest to credit managers. While TALF 2.0 is not yet up and running, and program specifics continue to be ironed out, using lessons from the original program in 2008, it is anticipated that a wide variety of credit managers will look to participate in the launch of dedicated funds focused on TALF covered securities. The opportunity, however, won’t remain open forever.

**What is it?**

TALF was first established in 2008. As its name suggests, the program is designed to maintain consumer access to business and consumer loans by providing a trusted source of liquidity for certain types of newly issued asset-backed securities (ABS) backed by such loans.

**Here’s how it works:** The Fed will create a special purpose vehicle (SPV) to facilitate loans to each participating borrower. The TALF SPV initially will make up to $100 billion of loans available to the market. The loans will have a term of three years, will be nonrecourse to the borrower, and will be fully secured by eligible ABS. The original TALF program, which was largely considered a success by most market constituents, paid all loans in full on or before their maturity dates. For ABS investors, it’s instructive to look back to 2008 for indications of how it will work today. ABS investors under TALF 1.0 received loans directly from the Fed to invest in ABS. They then pledged that ABS as collateral for the Fed loan. The Fed generated guaranteed liquidity results in the continued issuance of ABS and direct loan origination, a much-needed financial device to grease the wheels of the real economy.

Under the original TALF program, a number of hedge and private equity fund managers participated in the program to provide necessary liquidity to this important sector of the economy. It stands to reason that many will participate in TALF 2.0.

### Key Market Observations from TALF 1.0

1. Historically, managers and investors who got in early saw very good returns. It’s uncertain whether the market dynamics will play out the same way for TALF 2.0, but the key variables to watch are the timing of fund launches and secondary market spreads.

2. The original TALF lent itself well to private, closed-end Delaware structures and to credit managers with specific experience in the securitization market. However, it is possible for open-ended private funds to gain exposure to TALF assets through the use of SPV entities with side pockets.

   Newly created funds are typically fully funded at launch (no drawdowns) with a three-year time-horizon and at least $100 million in capital. Most products have a management fee and carried interest. UBTI, ECI, and ERISA considerations are likely to arise and managers should seek appropriate tax and legal advice prior to fund formation.

3. In the early stages of TALF 1.0, roughly half of the issuances in the market were financed by the facility (the impact the Fed was seeking); TALF issuance lagged significantly by the end of the program as spreads returned to normal.

4. While TALF 1.0 was largely considered a success by the Fed, which is why it’s being resurrected, there were some purported abuses. Look for the Fed to tighten up some of these loopholes in the coming days before the final rules are announced.
Fed term sheet: Some minor strings attached

TALF 2.0 has a set of terms and conditions laid out in its term sheet. The term sheet was originally published on March 23 and updated on April 9. The Fed has also expressed its commitment to ongoing consideration of the feasibility of adding other asset classes to TALF 2.0 program. As such, all program parameters remain open to revision, but are largely like those of the original program, and include:

- The initial aggregate size is **up to $100 billion**
- **The borrower must be a business entity created or organized in the US** or under the laws of the US and that has significant operations and a majority of its employees based in the US
- **TALF 2.0 loans will have a maturity date of three years**
- **All TALF loans are subject to the conflicts of interest requirements of Section 3019** of the Coronavirus Aid, Relief, and Economic Security (CARES) Act
- **The loan amount must equal the market value** of the pledged collateral less a haircut and administration fee
- **Loans made under TALF are non-recourse to the borrower**, provided the requirements of TALF are met
- **Prepayment of TALF Loans in whole or in part is allowable**, but substitution of collateral during the term of the loan generally will not be allowed
- **The haircut schedule is being finalized**, but is largely based on sector, weighted average life (WAL), and historic volatility of the ABS, similarly to the original program
- **Collateral to a TALF loan must be a US dollar denominated ABS** issued on or after March 23, with a credit rating in the highest investment grade category from at least two rating agencies, and backed by substantially all newly originated loans
- **Eligible collateral does not include ABS** that bear interest payments that “step up” or “step down” to predetermined levels on specific dates
- **Broadened range of eligible collateral** including Collateralized Mortgage Backed Securities and Collateralized Loan Obligations (CLO’s include a 25-basis point higher interest rate than all other collateral)
- **The interest rate for eligible ABS** with underlying credit exposures that do not have a government guarantee will be **125 basis points (bps) over the 2-year OIS rate** for securities with a weighted average life less than two years, or **125 bps over the 3-year OIS rate** for securities with a weighted average life of two years or greater
- **Unless extended, TALF 2.0 loans will be available until September 30, 2020**
- **The Fed’s SPV will charge an administrative fee** of 10 bps of the loan amount

The eligible underlying asset classes contained in TALF 2.0 are substantively in line with TALF 1.0, with the notable exception of the exclusion of commercial mortgage-backed securities (CMBS). There continues to be a flurry of vocal industry calls for expansion of TALF 2.0 to include other asset classes including CMBS, but also other mortgage and loan types which meet the “investment grade” criterion as well as legacy ABS (pre-March 23 issuances). There are also suggestions that the Fed should allow more flexibility on maximum loan maturity dates – a key learning gleaned from the original TALF.

A link to the latest Fed’s TALF 2.0 term sheet can be found **here**.

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