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The TALF 2.0 Opportunity in Asset Backed Securities

The U.S. Federal Reserve has revived its Term Asset Backed Securities Loan Facility (TALF), a successful securities financing program from the Great Financial Crisis of 2008 – 10. Back then, investors in asset-backed securities (ABS) with TALF leverage had a very positive experience.

Expectations for "TALF 2.0," part of the Fed's COVID-19 response, need to be tempered. While more realistic terms for CLOs and the expansion of TALF to term unsecured consumer loans and non-qualified mortgages could improve return prospects, the current spreads on targeted assets and the financing terms being contemplated look likely to result in levered yields in the high single digits or low teens.

While the return prospects today are not as impressive relative to the first TALF, in our view they can still represent a compelling prospect. We believe that Neuberger Berman's differentiated capabilities as a manager of strategies that issue as well as invest in ABS presents investors with the potential for better TALF-related outcomes.

The Federal Reserve has adopted an aggressive policy stance against the economic challenges posed by the COVID-19 pandemic. Amongst its policy tools to help maintain the flow of credit, in March it established a new TALF that will extend borrower-friendly, non-recourse, non mark-to-market loans to finance investments in high-quality, AAA rated ABS and commercial mortgage backed securities (CMBS).

The Fed's intention is to foster the extension of private capital to the asset-backed market, in turn securing the availability of credit to the economy. ABS and CMBS are critical components to the supply of credit to the consumer, residential, corporate and commercial real estate sectors, with issuance in the U.S. totaling $563 billion in 2019. We would note that the reason for the rapid increase in the cost of capital earlier in this crisis meaningfully differs from the Great Financial Crisis. The sudden halt of economic activity in response to the COVID-19 pandemic is arguably one of the "unusual and exigent" circumstances envisioned in Section 13(3) of the Federal Reserve Act, which empowers the Fed to lend against collateral like ABS which are beyond its usual policy instruments. The reboot of the TALF and related facilities are among the expansive measures this Fed has rapidly deployed to confront our current economic challenges.

Tempered Expectations

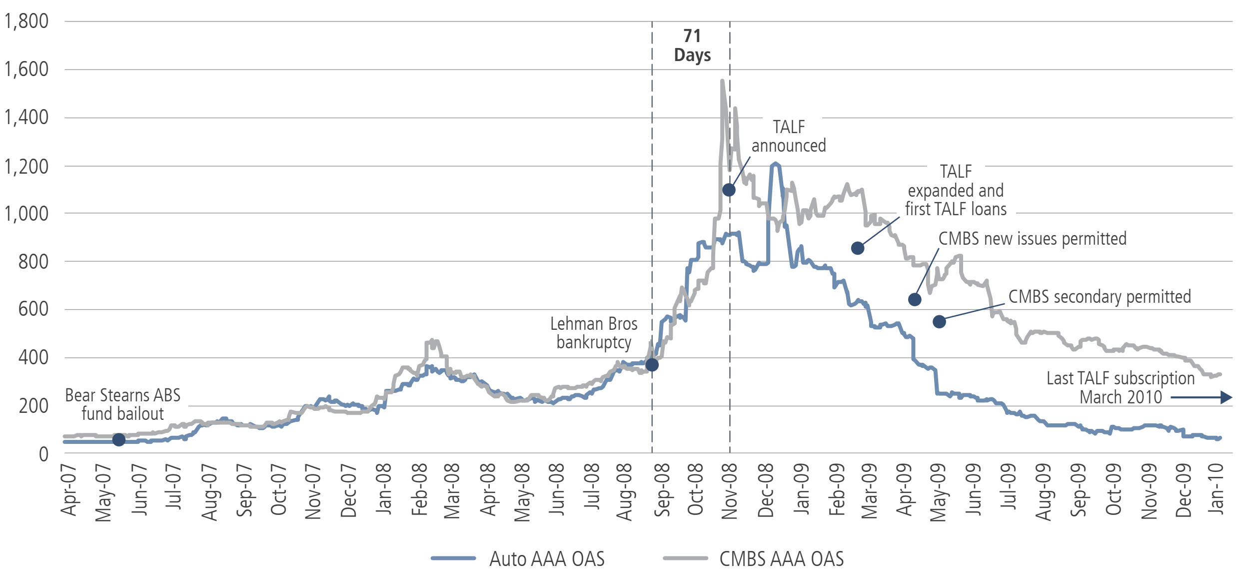
Many will recall that the Fed utilized this approach back in 2008. On balance, according to subsequent analyses of realized cash flows by Goldman Sachs Investment Banking and others, participating investors achieved outsized, double-digit returns from AAA bonds by utilizing the TALF leverage.

While still potentially attractive, we think investor expectations of TALF 2.0 should be tempered relative to those results. In part, the Fed's early action has contained ABS spread-widening relative to 2008, and that accounts for much of the difference between the equity-like returns achieved back then and the high single-digit or low-teens yields that are likely to be available on high-quality bonds levered with TALF 2.0, in our view.

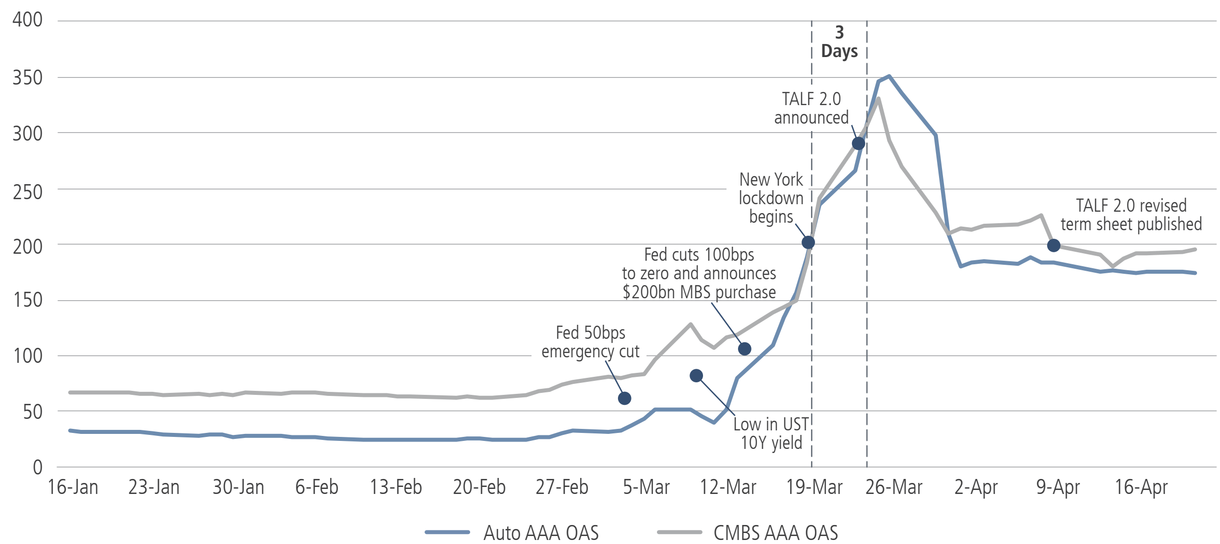
The levered yields available using the TALF loans would diminish further, of course, should ABS spreads continue to tighten—as can often happen with the mere announcement of Fed action. In fact, we see that prime auto and credit card ABS spreads are near or through the breakeven levels necessary to generate positive levered returns when the TALF financing terms are taken into account. Figure 1 shows the stark difference in the response timeframes between 2008 – 10 and 2020.

FIGURE 1. LESSONS LEARNED: RAPID RESPONSE IN 2020 VERSUS 2008 – 10

ABS spreads (basis points), 2008 – 10



ABS spreads (basis points), 2020



Source: Bloomberg Barclays. Indices referenced are the Bloomberg Barclays U.S. Non-Agency AAA CMBS Index and Bloomberg Barclays ABS Auto AAA Index.

Eligibility

Investors are keen for more specifics from the Fed. The terms and conditions for TALF 2.0 are currently limited to a three-page term sheet. After the initial announcement in late March, various structured finance industry groups approached the Fed to argue for a more impactful policy. Expanding the set of eligible securities beyond the consumer sub-sectors such as credit card, auto loan and lease ABS would in our view increase the efficacy of the TALF.

The market therefore anticipated a revision to the initial TALF 2.0 terms, and while the latest term sheet, dated April 9, did indeed expand eligibility to secondary CMBS, it created more questions about the sub-sectors that remain unlisted and about the terms under which it included collateralized loan obligations (CLOs). Notably absent were non-qualified residential mortgage and term unsecured consumer loans—both key components in the supply of consumer credit and obvious targets to fulfill the policy objectives. Furthermore, the current description of eligible CLOs virtually precludes the entire asset class.

Inclusion of these assets would likely enhance the overall TALF 2.0 investment opportunity, given their relatively elevated current unlevered yields. The nature and enormity of the current crisis and the Fed's broadly aggressive actions so far gives us reason to believe that they may ultimately be included.

Compelling Risk-Adjusted Yields

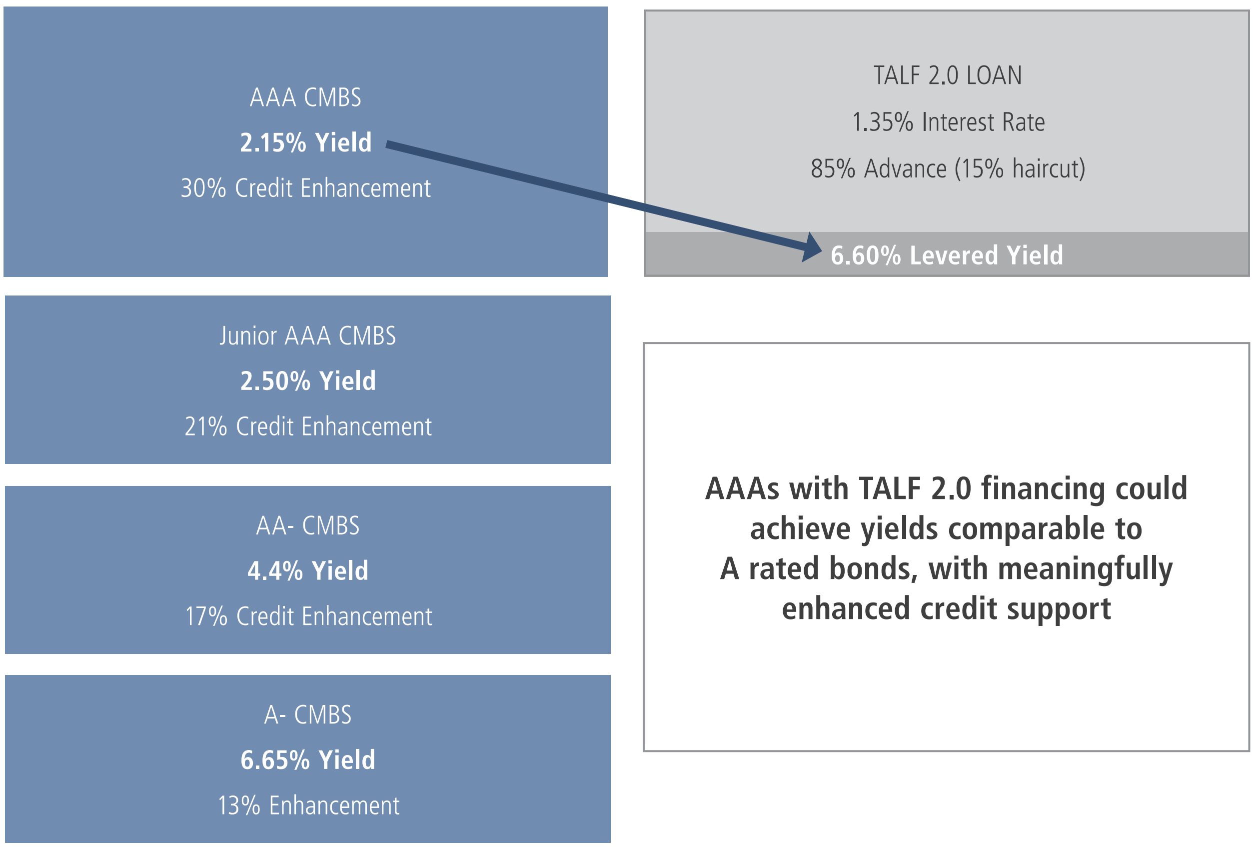
Nonetheless, even as TALF 2.0 is articulated today and at current valuations, we believe it can generate attractive risk-adjusted yields. Under the program, the Fed extends loans with haircuts ranging from 5% to 22%, which is generally consistent with those applied in 2008.

Consider the following example of a possible CMBS investment—bearing in mind that the following data were correct at the end of April and spreads are currently volatile. Without TALF leverage, three-year AAA CMBS with at least 30% credit support (in other words, for these bonds to experience principal impairment, pool losses must exceed 30%) are trading with yields around 2.15%. For comparison, unlevered A- rated securities with 12–17% credit support, or approximately half of the credit protection available to the AAA bond, are trading with yields around 6.65%. With TALF financing at a rate 125 basis points over the three-year OIS rate, a haircut of 15%, no requirement to mark to market and effectively consistent leverage, we estimate that an investment in a AAA CMBS bond would have a 6.6% levered yield—close to the unlevered yield of the A- rated bond, but with twice the credit protection (figure 2).[1]

[1] The illustrative estimated TALF levered yields are derived from our observations of current market levels. We see that three-year AAA CMBS trade at approximately 175 basis points over the swaps curve to produce a 2.15% yield. TALF financing terms would indicate a haircut of 15% and a financing rate of 1.35% (the three-year OIS rate plus 125 basis points). The resulting levered yield calculation is therefore 2.15% on the 15% haircut; plus a net of 0.80% (2.15% less the TALF financing rate of 1.35%) levered 5.7 times (85/15), or 4.6%, on the 85% advance; giving a levered yield of 6.68%. The simplified illustrative analysis does not include the TALF fee of 10 basis points of the loan amount, nor any additional costs or fees an investment strategy may incur.

We would note that the outstanding market value of AAA bonds across the curve in the Bloomberg Barclays U.S. CMBS Index is $257 billion, while there is $15 billion of A- rated bonds in the index.

FIGURE 2. ATTRACTIVE COMPELLING RISK-ADJUSTED YIELDS ACHIEVED THROUGH THE TALF



Source: Bloomberg, Neuberger Berman, Federal Reserve Bank of New York. Based on our current observations of A- rated CMBS bonds trading near 625 basis points over swaps and an illustrative capital structure comparable to a 2013 vintage conduit CMBS. For illustrative purposes only.

Importantly, we believe that the ultimate outcome of an investment program using TALF 2.0 financing will depend largely on the portfolio manager's capabilities. We think that Neuberger Berman stands apart in its ability to execute TALF investments because, as well as maintaining a fixed income active management platform underpinned by global research capabilities, we also manage strategies that themselves structure and issue ABS. Our CLO specialists have issued 36 CLOs since 2004; our mortgage team has executed over $5.6 billion of non-qualified mortgage securitizations since 2014 and deployed over $9.3 billion of capital since 2012; and our specialty finance team has evaluated more than 150 consumer loan originators and deployed over $1 billion over the course of their careers.

We believe that this is a differentiating advantage. Because Neuberger Berman possesses these capabilities we have additional insights into collateral quality and security selection, deep relationships with other ABS issuers and bankers that enhance our ability to acquire bonds, and experience in building solutions that match investor demands to the specifics of the opportunity set.

The TALF 2.0 investment opportunity, in isolation or part of a broader strategy, could yet be meaningfully enhanced by the Fed expanding the kinds of securities that are eligible under the new program. In simple terms of risk and reward, investing in AAA securities with TALF financing is compelling, as it stands today. As part of Neuberger Berman's recently published Playbook for the COVID-19 recovery, we believe that TALF-financed ABS could have important roles to play in both the "Durable Income & Yield" and the "Dislocation" themes.

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