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Term Asset-Backed Securities Loan Facility ("TALF") 2.0

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The opportunity in a nutshell

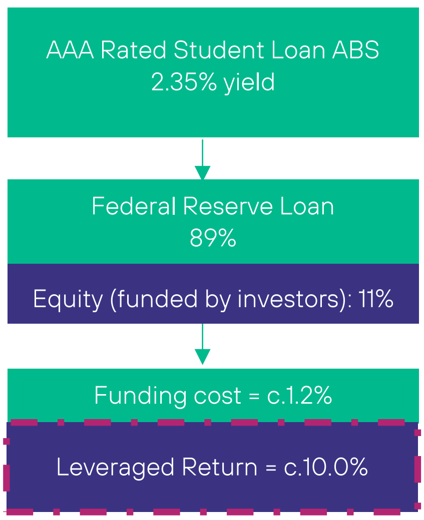
- Term Asset-Backed Securities Loan Facility 2.0 ("TALF") was announced by the US Federal Reserve (the "Fed") as a response to the COVID-19 related distress in financial markets. The primary aim is to improve the conditions in Asset Backed Securities ("ABS") markets, thereby increasing the flow of loans to consumers and businesses.
- The TALF vehicle will make an initial $100bn of loans on a non-recourse basis to buyers of certain AAA-rated ABS (US ABS only). The Fed will lend an amount equal to the market value of the ABS, less a haircut – which is provided by investors. Fundamentally, investors can purchase newly originated AAA ABS by using leverage provided by the Fed at favourable terms (an investor cannot lose more than their investment, unlike most leveraged investments).
- Eligible managers are hastily raising funds that are expected to close in short-order. This means there is a very narrow window for investors to commit and make an allocation – the opportunity therefore lends itself to those who can move quickly, with readily available capital to deploy.
- There are several considerations for investors to be aware of, including the potential for the opportunity to dissipate quickly, resulting in capital not being deployed, and potential US Dollar currency exposure.
- **We believe this is an attractive opportunity for investors who have the capacity to allocate 5-10% of their portfolio, over a 3-year period. The opportunity is expected to generate relatively high returns (6 - 9% net) by taking AAA rated credit risk, which is diversified across consumer, corporate and real estate sectors. However, the decision must be made quickly. Please reach out to your Isio contact to discuss this further.**

Background

COVID-19 has had a material impact on the functioning of global financial markets, with central banks and governments reaching deeper into their toolboxes than ever before – but have not neglected the tools that have served them well in the past. Following the Global Financial Crisis in 2008, the Fed launched TALF 1.0. This was deemed a success, and as such, the Fed have reopened the facility.

TALF 2.0 is intended to support lending to businesses and consumers, by incentivising investors to purchase the financial instruments that typically hold these loans – Asset Backed Securities.

Example investment



How it works in practice – an example

The Fed will lend investors an amount equal to the market value of the AAA rated security, less a predefined portion of equity (this is called 'the haircut', typically in the 5-15% range) – this represents the required investment from investors. Investors will then enjoy the yield of the full security, less the cost of borrowing. Loans will be provided for either two- or three-year periods.

- Over a 3-year period, based on indicative spreads and funding costs, investors can earn returns in the region of 6-9% on AAA rated ABS assets.
- Loans provided by the Fed are non-recourse, which means that the only 'skin in the game' investors have is the capital they provide. Should this be lost, investors can walk away (we expect this to be a low probability event). This is different to typical leveraged investments, where the value can fall by more than the invested amount.

- This works on the basis that the purchased asset has an equal life (i.e. maturity) to the loan, providing there are no defaults/losses along the way, the asset's price movements would not impact returns.
- The example shown is just one type of ABS a manager could use. In practice, the manager would construct a diversified portfolio made up of different sub-assets.

How to access the opportunity

Managers are currently raising capital for funds and are expecting to close shortly (by early to mid-June in some cases), providing a small window for investors to sign up to these funds. We expect funds to have the following characteristics:

- **Allocation:** Diversified exposure to underlying eligible US AAA rated ABS
- **Fees:** c.0.50% p.a.
- **Fund term:** 3-years, in line with the TALF 2.0 term
- **Return expectations (spread dependent):** 6-9% net IRR

Risk considerations

As part of a commitment, there are considerations investors should be aware of:

Default and losses could erode investors' capital

Whilst this risk cannot be ignored, comfort can be gained through a few factors:

- AAA rated tranches of ABS have a track record of robust performance through previous crises, suffering little to no losses.
- Initial analysis shows TALF eligible assets could experience on average 2-3 times higher loss rates than ever before and the AAA tranche would remain intact.
- Loans are non-recourse, and so any downside would be capped.

Persistence of the opportunity

The facility to borrow from the Fed is currently only open from 17 June to 30 September 2020 – with the expectation that the most attractive returns will be available at the beginning of the period (whilst the spreads are attractive). If TALF 1.0 is anything to go by, this window could be extended, but this is not guaranteed.

Further, should spreads fall below a 'breakeven point', then the opportunity itself will have naturally dissipated. Should this occur and cash had not been deployed, managers would return capital to investors. Likewise, the opportunity relies on a functioning ABS market and new issuance from market participants.

The current opportunity to invest in a TALF 2.0 fund is compelling – offering attractive returns for investing, using leverage from the Fed on favourable terms, in AAA rated US Asset Backed Securities.

This tactical opportunity is suitable for investors who have the flexibility to allocate 5-10% of their portfolio, with a clear understanding that there is a possibility that money could be returned without being invested, if markets move from this point.

The decision will have to be made quickly and we therefore encourage any investors who are interested in hearing more about this opportunity to engage with their Isio point of contact at the earliest convenience.

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