

EUROMONEY

US banking: What it will take for Talf to take off

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Tuesday, May 05, 2009

Two months in and only \$6.4 billion in Talf loans from the \$200 billion programme have been taken up. The number of investors lined up to participate is increasing and Ben Bernanke could end up with his \$1trillion dream of Talf issuance and a revival of US consumer lending. Issuers need to get on board. But will they? Helen Avery reports.

WHEN FEDERAL RESERVE chairman Ben Bernanke came up with the Talf programme in November 2008, it was with one aim in mind – to revive the securitization markets. The term asset-backed securities lending facility was conceived as a way to jump-start new issuance in the ABS market, meeting the credit needs of households and small businesses, for which lending had dried up as the financial crisis hit home.

Providers of student loans, credit card loans, auto loans, and small business loans had stopped lending as they were no longer able to package up the loans and sell them on to end investors in securitized deals. The Fed hoped that by offering investors an incentive to buy securitized loans, issuers would return, and with more consumer loans available, the appetite to spend would increase, helping to lift the country out of recession. The Fed would lend money (up to \$1 trillion eventually) on a non-recourse basis to those buyers of newly and recently originated AAA-rated asset-backed securities, which would be used as collateral. By doing so, the increased supply of investors would make it cheaper and an encouragement for lenders to return.



On a given day each month, investors can apply for one or more three-year maximum loans of a minimum of \$10 million each to invest in Talf-eligible securities. How this would not appeal to investors was inconceivable to the devisers of the programme. The cost to the investor in the short term is just a five basis point fee payable to the Federal Reserve Bank of New York, and the loans have minimal interest rates – that means the Fed is paying 95% of the cost of the assets bought until the loan has to be paid back.

But issuance has been disappointing. Only \$11 billion-worth of Talf-eligible deals have been launched and only \$6.4 billion in Talf loans has been taken up. Investors are coming around to the idea but without issuers Talf will be dead in the water.

Overcoming obstacles

Despite reports in the media that interest in Talf from investors has been limited, several investment firms say they are taking part in the programme or plan to do so. They include Blackrock, Treesdale Partners, NuVerse Advisors, Pimco, and Paramax Capital Partners. Investors keen to participate have, however, had to overcome numerous obstacles. Setting up the domestic vehicle to invest in Talf is relatively straightforward but investors say the second part of the process – signing up with primary dealers – has been problematic. In order to apply for eligibility for a Talf loan, investors must sign customer agreements with the primary dealers selected by the Federal Reserve. The investors can then put in their orders for loans one or two days before the Talf-eligible issue closes. A third-party marketer to a hedge fund says that his client has been frustrated by the relatively slow response by primary dealers in signing people up. One primary dealer, he says, has yet to finalize customer agreement contracts. "When the deadline is this December, you have to question the commitment," he says. In the dealers' defence, he adds that 11 changes to the programme have already been made by the government that primary dealers have had to rework into their contracts.

Stephen Saali, managing partner at NuVerse Advisors in New York, agrees that the primary dealers have had their work cut out preparing documentation. "They have had to sign an agreement with the government but there have been many changes," he says. "While it is in their interest to originate more product, it is time-consuming going over the frequent changes to the programme. In order to cut down on time, and in some respects to cover themselves, they have passed on the burden of providing legal indemnities, representation and warranties to the end investor. From a legal perspective it is a lot for the potential Talf investor to deal with, and has probably discouraged some – particularly initially, when such investors were still unsure that the programme would take off."

Barclays Capital has been a lead bookrunner in several of the Talf-eligible deals. Craig Leonard, a structured debt syndicate banker at the bank in New York, agrees that the customer agreements were initially an obstacle but says his firm and others in the dealer community have been diligent in preparing contracts that are "fair, with risk being better balanced between the investor and the broker/dealer". The result has been increased interest from the investor community.

But the Federal Reserve is not making it easy on investors. Information on the Talf website stated that there was an H1B-visa limitation

for Talf loan borrowers, preventing foreign employees from being newly employed. Saali says: "This is difficult for global companies such as ourselves that operate in areas away from Talf investing." NuVerse runs several hedge funds for high-net-worth individuals, in addition to providing private banking level services. "We need specialists in local markets but to be eligible to apply for Talf loans we will be prohibited from bringing on foreign employees now. It can be damaging for businesses." At the time of going to press it was rumoured that the limitation had been accidentally included in the Talf guidelines and was meant to apply only to Tarp recipients, and so might be removed.

More recently, the question of limits on executive compensation has further discouraged Talf take-up. "When Talf was originally announced, investors were told they would not be subject to compensation restrictions but that issuers would," says a manager. "Then that restriction was dropped, but now there is talk that investors might be subject to retroactive taxes or executive compensation restrictions. These uncertainties create a difficult investment climate. What if a fund participates in Talf and is later told that the profits it earned have to be returned?" Timothy Geithner has said this is not the intention, but the general lack of agreement between Congress and Treasury has caused concern that there will be retroactive taxes or changes to compensation.

Return potential

With so many discouragements, it is surprising any investors would want to participate. The first round of Talf loans applied for in March totalled \$4.7 billion, and the second round in April decreased to just \$1.7 billion. But the return potential goes some way to counterbalancing the hard slog involved in setting up. NuVerse's Saali says the returns were compelling for the firm's clients. "Risk-free yield for three years runs at around 1%," he says. "With up to 20 times leverage on a non-recourse basis on triple A assets you are looking at potentially 20% returns on a relatively risk-free basis. We are, though, taking a more conservative view that returns will be in the low to mid-teens."

Ron Weibye, head of structured credit at Treesdale Partners, which has already made Talf investments, says the leverage is appealing to investors. "In this market, investors generally do not want to use leverage," he says. "Aside from Talf we don't employ any additional leverage in the distressed MBS market at this time. Talf, however, allows investors like us to participate in trades that would not normally need our target rates of return."

The size of potential returns cited by investors range from low double digits to, in one instance, 30%.

So where is the risk? Ultimately, it lies in whether the subordinated portions of the Talf-eligible deals get eaten up by defaults. The structure of the Talf deals differs from normal ABS deals in that 15% to 30% of the deal is in subordinated debt, and the remainder in triple-A debt that is eligible for Talf investors. Although this is seemingly a high buffer for Talf investors, in the present economic environment it is not unthinkable for defaults to eat into the triple-A tranche and adversely affect those double-digit to 30% returns.

"To say that the Talf loans are without risk would be incorrect," admits Saali. Triple-A ratings by ratings agencies have unfortunately become less reliable in the present financial crisis. "You need to do proper credit analysis," Saali says. "Is there enough subordination there? What is the default risk?" He points out that there can be differences among an issuer's default risks. An example would be a pool of Washington Mutual's credit cards and those of Chase. Although both card brands are owned by JPMorgan, holders of WaMu credit cards are much more likely to default than Chase card holders.

Indeed, defaults on credit cards in the US are rising, prompting concerns that the subordinated tranches might indeed not be sufficiently substantial. That said, Saali believes prepayment of debt is a more serious risk than default. He says: "It was largely opined that US consumers were more concerned about repaying mortgages than repaying credit card debt or auto loans. There was believed to be a stigma attached to losing one's home. That has been largely disproved, and some consumers, now owing more on their houses than they are worth are opting to walk away and pay off credit cards first. In the US, credit cards are vital for consumers, and cars are of second importance as they are required to get to work and for families. When some of these models have been disproved or broken, it can be hard to trust a rating."

Not all investors have the expertise or resources to analyse thoroughly the underlying credits of Talf issues, and some might end up being caught out. At 20 times leverage, there is the risk that capital could be wiped out. A lack of credit expertise could also be a reason why some investors are being deterred.

The structures of the Talf loans also have inherent risk. Investors can borrow at fixed or floating rates from the Federal Reserve, and Talf issuers' coupons can be paid at fixed or floating rates. If there is a mismatch between borrowing terms and issuing terms, the investor is opening himself up to interest rate risk. There is also a mismatch in duration. The Talf loans to investors are for three years, while Talf-eligible issuance can have a maturity of up to five years.

TALF-eligible issuance to date				
Date of issue	Issuer	Deal value (\$mIn)	Amount retained by issuer (\$mIn)	Bookrunner
19 Mar '09	Nissan Auto Receivables 2009-A Owner Trust	1,369		JPMorgan, Bank of America/Merrill Lynch
20 Mar '09	Citibank Credit Card Issuance Trust	3,000		Citi
20 Mar '09	Ford Credit Auto Owner Trust 2009-A	2,954	775	JPMorgan, Goldman Sachs, Deutsche Bank, RBS, Bank of America/Merrill Lynch
20 Mar '09	Huntington Auto Trust 2009-1	963	132	Barclays Capital
Total first round (\$mIn)				8,286
7 Apr '09	CarMax Auto Owner Trust 2009-1	980	322	JPMorgan, Bank of America/Merrill Lynch
7 Apr '09	World Omni: Auto Receivables Trust 2009-A		750	Barclays Capital, Bank of America/Merrill Lynch
8 Apr '09	World Financial Network Credit Card Master Trust	708	148	Barclays Capital, JPMorgan, RBS, RBC Capital Markets, Wells-Wachovia Securities
14 Apr '09	Alliance Data Systems	709	149	JPMorgan, Barclays Capital
Total second round (\$mIn)				3,147
Source: Dealogic				

Although there are risks, investors are increasingly recognizing the programme's return potential. Although only \$6.4 billion in loans has been granted, the \$11 billion in Talf deals launched was oversubscribed. One explanation is that the deals were picked up by investors that are part way through loan applications. An increasing number of funds are also announcing plans to start up Talf funds. "We like the projected returns of the deals thus far, and Talf appears to have been well received on the investor end," says Weibye. "We expect greater competition from additional investors as in the next six months. If there is hesitation, it seems to have been greater on the issuer side."

Issuer reluctance

Overcoming issuer reluctance stands to be the biggest decider for whether Bernanke's Talf dream will be a reality or a flop. The programme's success ultimately depends on how much issuance can be generated. As yet, just eight deals, totalling \$11 billion, have been launched. At some level, investors say issuers are wary about getting involved with government projects, as they too to some degree are. "Issuers have seen the banks accept Tarp relief and be dragged through Congress, and understandably they now worry that could happen to them at some point in the future," says a hedge fund looking to participate in the facility. Whether issuing in the Talf programme is cost-effective is often cited as a reason why issuers are unforthcoming. The banks, for example, can obtain cheaper funding from the government than through issuing in the ABS market and placing subordinated debt. Citibank's \$3 billion Talf deal, however, seems to undermine this argument.

It might be argued that Citi deemed it politically advisable to show willing and issue into Talf but primary dealers take a less conspiratorial view. One says: "When you look at the last 10 months, so many parts of the markets that issuers would turn to for funding have closed. Talf might be more expensive than other sources of funding but diversification of funding is important. Some banks might follow Citi and want to strike a balance between cost and diversification." Citi did not return calls to clarify its motives for issuing under Talf. Weibye agrees with the primary dealer. "Issuers have an incentive to open up as many avenues of financing as they can – so long as costs are not way out of line," he says.

So is it that the subordinated tranches are deterring issuers? As previously discussed, Talf issues are structured as 15% to 30% subordinated debt that is not eligible for Talf loans, and 70% to 85% in triple-A-rated debt that Talf investors can purchase with the Fed's leverage. Saali says: "Ordinarily, the subordinated tranche is shared between a bond insurer, the issuer, the investment bank and other investors which are prepared to take on risk for a higher yield. The bond insurers have gone, and issuers, investment banks and other parties that would have taken that tranche have less appetite for risk now. So placing 15% to 30% rather than, say, 10% of the subordinated debt is more difficult, particularly in an economy such as this one. In order to get a Talf deal done, there has to be that placement of the subordinated portion of the deal."

One primary dealer says that those banks in the business of underwriting bonds and raising money for issuers should not be deterred. "If you are a bank that is an intermediary in the ABS market, your job is to maintain your relationship with issuers and place deals. It is not necessary to use up a balance sheet to be an underwriter if you are a global bank with access to end investors with appetite."

Barclays' Leonard says that although issuance dwindled in April, he expects volumes to trend upward in future months as issuers see more deals executed successfully and become increasingly comfortable with the programme. He also points out that all four of the issuers that came to market during the April subscription period saw a spread tightening to where they would have priced outside of the programme.

The biggest sticking point for issuers, believes Weibye, is simply the uncertainty and confusion surrounding the Talf programme. So many changes have been made already, with possibly more to come, that issuers have been scared away. "It is a shame, as Talf certainly was formed under good intentions and I believe it has legs and could certainly accomplish the government's objectives of reviving consumer lending," he says. "It wasn't rushed through, and did have a gestation period between November and March. So unlike some of the other programmes discussed, such as PPIP [public private partnership investment programme], Talf is real, and up and running. If issuer trust increases then we could see many Talf deals come to market successfully but it is up to Washington to instil that confidence." Distinguishing Talf as separate to PPIP will be important. PPIP proposes the sale of banks' toxic assets to investors in partnership with the government and has been slammed before proposals have even begun to take shape. Essentially, the programme is regarded as another bank bailout and investors are confused as to how the assets would even be priced. Discussion in government conversations alongside Talf could tarnish the latter's reputation, not to mention adding to the acronym overload.

But Washington, or at least parts of Washington, is trying to promote Talf. The list of assets eligible for Talf deals has been increased, and it is mooted that commercial-backed mortgages and some non-agency mortgage-backed securities might become eligible for Talf issues. Confidence will be more easily restored if more issuers are allowed to participate, and greater comfort will be provided. "Inclusion of other asset classes has also generated more interest on the issuer side," says Leonard. "The fact that the programme is working and that issuers can see the flow of funds gives them greater comfort to get in line to issue in the next couple of months."

But time is ticking by. Talf issues are undertaken only once a month and are due to end in December. At only \$11 billion, we are a long way off the hoped-for \$1 trillion issuance. Investors are willing but only if issuers can be nudged into action will there be any chance of success.

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