



## MEMORANDUM

DATE: June 2009

TO: All PCA Clients

FROM: Pension Consulting Alliance, Inc. (PCA)

RE: **Review and Investment Recommendation on TALF Investment Opportunities**

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### **Background**

In response to an unprecedented lack of liquidity in the credit markets the Federal Reserve Board announced a number of unparalleled policy initiatives in hopes of restoring liquidity to important segments of the financial markets. One of the initiatives is the Term Asset-Backed Securities Loan Facility. The Term Asset-Backed Securities Loan Facility (TALF) is a loan facility created by the Federal Reserve Bank of New York (FRBNY), with assistance from the Treasury, designed to improve the availability of credit to consumers by restarting the secondary market for consumer-oriented Asset Backed Securities (ABS). The FRBNY intends to create liquidity by providing attractive financing with generous loan terms to investors who purchase newly created (2009 vintage) eligible ABS issuance (i.e., the loan “collateral”). The Program looks to narrow current ABS spreads in expectation that lower spreads will translate into lower borrowing rates for consumers and small businesses.

The financing options allowed under the TALF Program allow investors to, in principle, lock in a “spread” between historically high yields on high-quality ABS issuance and the attractive rates offered under TALF. As the TALF Program has become more formalized over the last several weeks, the investment community has developed investment vehicles to exploit the TALF opportunity. This memo reviews the various aspects of the TALF Program and provides a general overview of how investments in TALF might perform.

### **Recommendation**

PCA has reviewed the features and structures of investments associated with the U.S. Government's Term Asset-Backed Securities Loan Facility (TALF) Program. While there are numerous tradeoffs (see below), PCA believes that TALF-oriented investments offer investors the potential for attractive risk-adjusted returns that will be available for a limited period of time. Therefore, PCA believes its clients should examine closely the merits and concerns of the TALF Program



### Summary of TALF Program Merits and Concerns

Merits	Concerns
<ul style="list-style-type: none"> <li>• Potential for double-digit returns generated from investing in high-quality debt for providing liquidity in an illiquid marketplace.</li> <li>• Investment process can “lock in” the spread between interest earned on investments and interest paid on loans to finance investments.</li> <li>• Government-sponsored program needing to produce successful results.</li> <li>• Government is offering highly attractive financing rates to participating investors.</li> <li>• Exploiting fixed income credit-oriented dislocation that will likely diminish materially within a short time frame.</li> <li>• Receivables pools from very high quality corporate issuers have issued debt under TALF (Toyota, USAA, Honda, etc.).</li> <li>• A number of experienced and talented investment management firms have created products that lever their credit analysis capabilities.</li> </ul>	<ul style="list-style-type: none"> <li>• Government-sponsored program may be subject to terms revisions in the future.</li> <li>• Credit risk analysis still required. Managers performing credit analysis on investment collateral will likely be some of the same managers that failed to mitigate the credit risks during the sub-prime crisis.</li> <li>• Highly leveraged positions. The degree of leverage magnifies the chance of loss.</li> <li>• Potential for high investor management fees and misalignment of interest.</li> <li>• Potential for term mismatch risk between investment collateral and TALF loan facility.</li> <li>• Potential headline/political risks (think TARP).</li> <li>• Lack of investment liquidity. Investors will face long lock-up periods while still being subject to potential capital calls.</li> <li>• These are “new and untried” assets/structures and there is no highly reliable manner to evaluate a manager’s experience/track record in a TALF-like program.</li> <li>• No assurance that interest-rate spread will be “locked in.” Investment managers may maintain discretion to determine floating versus fixed interest rate exposures for both collateral and loan facility.</li> <li>• Portfolio concentration risk. Only a limited number of issuers so far.</li> </ul>

The TALF Program has a limited life. The Government has indicated that it will cease making new loans under TALF on December 31, 2009 unless the Federal Reserve Board extends the facility. Due to this condition, investors and investment managers are working on a tight time table to evaluate and fund TALF Program investments. This means investors will not be able to analyze typical historic track records of investment performance results to determine if an investment is prudent. Instead investors will have to make an *ex ante* decision on whether to fund a specific TALF-oriented investment program. Overall, PCA believes its clients should participate in the TALF Program, but only after all risks, financial and non-financial, are fully taken into account.

If, after consideration of the pros and cons, a plan sponsor wishes to proceed with pursuing TALF Program investments, there are a number of factors that PCA views as important in determining the future success of the investment strategy. The single most important factor will be investment manager/fund selection. Investment manager selection will go far in determining whether the investor receives attractive returns or an unappealing outcome. Like any other credit-oriented fixed income investment, security selection remains a paramount concern when participating in the Program. A successful manager will not be able to rely solely on the rating agencies ratings when determining the attractiveness of a particular ABS. Instead a successful manager must be



able to complete the necessary due diligence into each potential investment. This will involve scrutiny of the underlying collateral and an independent appraisal of the assets, terms and conditions. These requirements will dictate, to a degree, which investment managers will be better suited for the Program. In addition, PCA's initial examination of investment fund terms and conditions indicate that not all funds are priced/structured similarly. As a result, such terms and conditions variability could have significant impact upon the final net realized returns to investors.

Finally, PCA recommends that clients seek out TALF-oriented investment opportunities that align the maturities/durations of the TALF-approved issuance to that of the TALF loan. PCA believes the most successful investments will be those that focus on buying TALF-oriented assets with three-year maturities so that the investment collateral matures at the same time as the loan facility, thus removing the potential mark-to-market risk present in having mismatched maturities. While this approach may not necessarily produce the highest internal rate of return (IRR), PCA believes that by limiting investments to those that match maturities, the investor removes one of the largest risk factors present.

### **Summary Description of the TALF Program**

The Term Asset-Backed Securities Loan Facility (TALF) is a loan facility created by the Federal Reserve Bank of New York (FRBNY) with assistance from the Treasury designed to improve the availability of credit to consumers by restarting the secondary market for consumer-oriented Asset Backed Securities (ABS). The FRBNY intends to accomplish this by providing attractive financing with generous loan terms to investors who purchase newly created (2009 vintage) eligible ABS issuance (i.e., the loan "collateral"). The investors stand to profit on the difference between the rate received from the collateral and the rate paid on interest for the loans.

#### *Fund Structure*

Investment funds that PCA has reviewed are structured as limited partnerships (or equivalent) in which investments will be drawn-down to fund investments. Such offerings vary in structures and terms. Expected term lengths vary between 3-to-5 years and expected general partner compensation structures range from a single flat fee based on net invested capital to the typical blended flat fee plus a percentage of investment profits (i.e., "carried interest"). The carried interest stipulation may contain a hurdle rate or preferred return.

#### *Execution*

On a set date each month, the loan subscription date, investment managers (borrowers) will be able to request one or more TALF loans from the FRBNY. The investment manager (borrower) at that time must indicate for each loan the eligible newly-issued ABS collateral they expect to pledge. They must also indicate the desired loan amount and the desired interest rate format for the loans, fixed or floating. Loan proceeds will be disbursed to the borrower (the investment manager), contingent on receipt by the FRBNY's custodian bank of the eligible ABS collateral. The minimum size of the TALF loan will be \$10 million.



## Rationale for Investing in the TALF Program

Through TALF, the U.S. Government has developed a process that allows institutional investment managers the ability to capture the positive difference between realized interest rates on certain investments and the interest cost of borrowing funds to make those investments. The investment manager's key objective is to lock in this spread between the two rates and make good credit decisions. By assuring a reasonable interest spread, the U.S. Government is making it attractive for investors to enter the TALF Program. For example, assuming an 8% haircut (8% initial margin) an investor must put up \$8 million of capital as initial margin, which results when fully leveraged to \$100 million in purchased ABS collateral earning interest. Assuming Libor is currently 50 basis points (bps), the ABS collateral is earning Libor plus 250 bps, and the FRBNY loan costs Libor plus 100 bps, the investment manager stands to make the spread as profit. In this case, the spread will be 1.62%, 300 bps multiplied by \$8 million plus 150 bps multiplied by \$92 million. A spread of 1.62% on \$100 million equates to \$1.62 million in earned interest. Since the investor has only put up \$8 million of capital, the \$1.62 million earned equates to a 20.3% cash-on-cash return annually. In the event that poor credit decisions are made the potential exists that investors can lose some or all of their capital (see table).

**Hypothetical Returns by Issuer Type\***

ABS	Theoretical 3 yr new issue spread	3 yr Haircut	Potential annual cash-on-cash return	Estimated Investor Breakeven Price Point <sup>^</sup>	Estimated Investor Total Capital Loss Price Point <sup>^^</sup>
Auto (prime)	250	8%	20.3%	95.1	93.2
Auto (subprime)	375	11%	26.5%	91.3	87.6
Credit Card (prime)	185	6%	15.7%	97.2	96.1
Credit Card (subprime)	225	8%	17.1%	95.9	94.0
SBA Loans	130	5%	17.0%	97.5	96.7
Student Loan (Private)	325	10%	24.0%	92.8	89.8
Student Loan (FFELP)	165	5%	24.0%	96.4	95.7

Source: PCA, AllianceBernstein and the Federal Reserve Bank of New York

\* Estimates are for reference purposes only. Values assume securities are purchased at par.

<sup>^</sup> Breakeven Price Point is the price at maturity at which the investor's leveraged investment return is zero. Values below the breakeven value signify investment loss while values above signify profit.

<sup>^^</sup> Total Capital Loss Price Point represents the price of the issuance at maturity at which the investor suffers a complete loss of their invested capital.

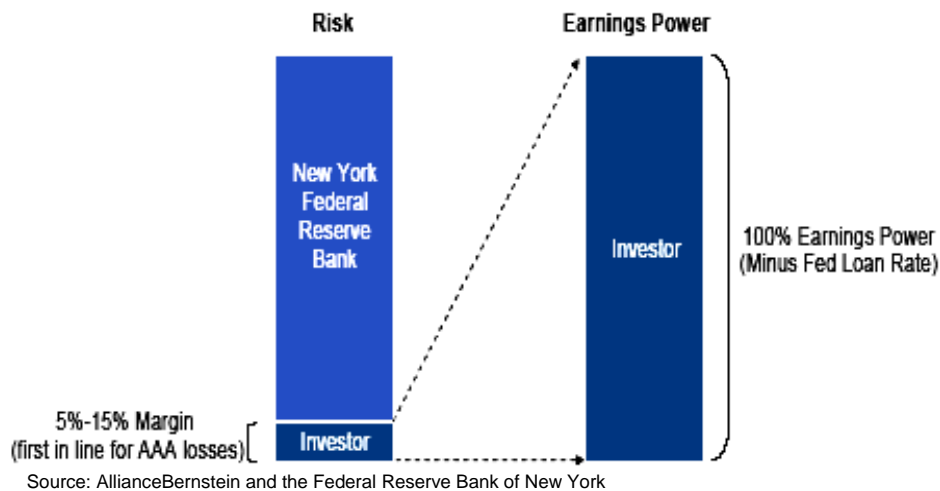
The above chart highlights theoretical indicative returns and breakeven values for potential investors. Actual spreads will vary depending on market conditions and the demand for the underlying collateral. Thus, investors in the Program might suffer from the success of the Program as spreads narrow and potential returns are reduced and breakeven values increase. The breakeven values represent the value at maturity at which the investor earns a zero return on invested capital. It is important to recognize that the breakeven point represents the value for the entire investment and not the breakeven point for a specific ABS. For example, a specific prime Auto ABS might have a security-specific breakeven point at 91. In other words, if an investor held the security unlevered the investment would breakeven; the investor makes no profit nor suffers any loss, at a maturity value of 91 cents on the dollar (due to the collection of interest payments prior to maturity). However, the TALF Program is based on leveraging eligible ABS in order to capture the interest rate spread between the interest earned on the ABS collateral and the interest paid on the TALF loans. The use of leverage amplifies returns, but it also increases the chance of loss (i.e., raises the breakeven value). Returning to the example above, but this time



assuming the use of leverage through TALF loans, the breakeven point increases from 91 cents on the dollar to 95.1 cents on the dollar. This means the investor stands to lose money if the value at maturity is below 95.1 cents on the dollar. In addition, the investor will suffer a complete loss of capital, the initial margin posted, if the same investment falls below 93.2 cents on the dollar. Importantly, an investor needs to be aware of the correlation between how close to par the breakeven value and total capital loss value are to the size of the leverage used. The smaller the required haircut (higher leverage) the closer the breakeven and total capital loss values are to par.

### Benefits of the TALF Program

- Potentially large returns. On a returns basis, the opportunity present in a TALF investment is considerable due to the favorable lending terms and the high quality issuance as collateral. There is the potential for highly attractive return on investment due to the large spread between the collateral and the TALF loans. This provides the investor with the potential to earn a high IRR, similar to higher-risk private equity and alternative investments on AAA rated short-duration fixed income assets.
- Non-recourse loans from FRBNY. One key characteristic of the TALF Program that makes it a potentially attractive investment opportunity is the non-recourse funding provided by FRBNY. This form of lending is stable and allows the investor to capitalize on leveraging the initial margin posted by as much as 20 times. This feature allows the investor to capture 100% of the earnings power generated from the investment while only posting a small fraction of the total capital (see graph below). The fact that the TALF loans are non-recourse to the borrowers (investment managers) limits the potential downside to the initial margin collateral posted.



- No mark-to-market accounting. Another potential consideration is the fact that the Program will not be under the mark-to-market restriction. In other words, the investor will not be required to post additional collateral if the ABS falls in value (i.e. no margin calls). This is a vast improvement upon other leveraged investments which are required to mark illiquid assets to market prices and post additional margin collateral, thus adding to the liquidity risk of the investment.
- Only high-quality assets are eligible as collateral. Eligible collateral is limited to high quality AAA ABS newly issued from major institutions which is then vetted and approved



by the FRBNY. TALF issuers currently participating in the Program include JP Morgan Chase, Sallie Mae, Honda, Toyota, Volkswagen, Harley-Davidson, USAA, and GE Capital. This focus on only high-quality collateral reduces the chance that an investor will take a loss on principle. Only the highest (senior) tranches of ABS have been eligible as collateral. Recently, the Program approved high-quality CMBS and RMBS as additional allowable security types under TALF.

## Concerns about the TALF Program

Concerns surrounding TALF led to a tepid initial rollout of the program. In March, only \$4.7 billion in TARP loans were made by the FRBNY through the Program. April data revealed a continued cautious outlook towards the Program with a meager \$1.7 billion in TARP loans being facilitated through the Program. However, issuance in May approached \$8 billion and an equivalent level is expected in June. Nonetheless, in aggregate, these results fall short of the U.S. Government's vision of supporting hundreds of billions of dollars in new lending. One of the main causes for the reluctance from investors is the uncertainty surrounding direct involvement with the Government.

- The Government could change the rules of the Program retroactively. This could take the form of new restrictions on the investor-borrowers and possibly even the issuers of TALF collateral. Thus far, the Government has not communicated clearly their intentions on the longer-term stability of the Programs policies and procedures. PCA views this lack of clarity as one of the main contributing factors that has resulted in the slow rollout of the Program. There are many potential unintended consequences inherent in the Program. For example, the Program has large political risks involved via its potential politicization. Policy makers have presented a willingness to politicize key financial initiatives when politically advantageous. For example, the AIG bonus debacle and the increased criticism of financial institutions receiving aid through TARP give evidence supporting this concern. One potential concern would involve the changing of underlying terms of issuance of the ABS collateral. In addition, legislation could be enacted that materially affects the value of the collateral which could cause potential losses for investors, such as new credit card regulations or changes to bankruptcy laws. Such legislation could be politically popular if politicians develop a scenario where TALF investors are making excess profits while consumers are burdened with onerous debts which form the basis for the investors' profits.
- The potential headline risk of being a participant in the Program. This potential risk has much to do with how policy makers and the media portray the Program. Policy makers and the media can portray participants as either saviors of an important segment of the financial markets or as profit seeking looters of the middle class. For example, policy makers have failed to delineate between the different firms that have receive assistance under TARP. Initially, TARP was portrayed as a Program designed to revitalize lending by providing capital to financial institutions and not as a bailout of certain firms. As such, the nine systematically important institutions were required to receive funds. However, as time has passed the Program has been characterized as a bailout and is synonymous to many as the pinnacle of mismanagement, poor leadership and judgment, and excessive risk. As such, the media and numerous policy makers have not wasted many opportunities to criticize financial institutions and their management. As of now, TALF does not have a particular stigma attached to it. However, that is most likely due to the small rollout of the Program and the fact that the size of profits made in the Program are not yet publicly known.



- Use of leverage. Investors in the program benefit from favorable borrowing terms from the FRBNY. The investors are looking to profit from the spread between the investment return and the borrowing costs. In addition, investors in the AAA tranche are protected from loss by the junior tranches that take the first losses in the underlying collateral. However, if losses in the underlying collateral are unexpectedly high, investors in the AAA tranche could suffer losses. The losses will be exacerbated by the leverage (possibly 10x or more) component of the program.
- Collateral's price at maturity may be below par. This risk is present in the TALF Program due to the fact that investment collateral utilized by the TALF Program is not backed by the Government. As a result, the credit risk associated with investing in TALF-oriented funds is analogous to credit risk that would be borne by any other more typical credit-oriented fixed income fund. Nonetheless, those corporations issuing eligible ABS under TALF have been screened and vetted by the Government, which has a vested interest in ensuring the Program is successful from an economic management perspective. At the end of the day, the credit risk ultimately resides in the consumer's ability to repay the underlying loans which comprise the individual ABS. The fact that only reputable companies vetted by the government are entitled to issue eligible ABS reduces the possibility of poor underwriting standards or outright fraud.
- There is a potential for mismatching the terms of the TALF loans to the underlying investment collateral. Under the TALF, an investor/borrower is not restricted in selecting the maturity of the eligible collateral. In other words, an investor can purchase ABS with varying maturities yet finance them with a three-year loan under TALF. As a result, there is mark-to-market risk should the collateral mature beyond three years and bond's price be below par at the end of the three year term of the loan. A key criterion when selecting a manager to invest in the TALF opportunity will be the understanding that they will match duration of the issued collateral and the commensurate TALF loan thus mitigating the inherent mismatching of terms risk. This risk has been somewhat muted with the recent FRBNY announcement that the Fed will offer five-year TALF loans for the use in purchasing CMBS and student loan backed ABS. The longer loan terms will allow investors to better match asset maturities to loan maturities. Due to the risk of mismatching collateral/loan duration/maturity it will be of the utmost importance to choose an investment manager who is aware of this risk and thus structures their product offering and manages the assets accordingly.
- The limited transferability of the collateral and loan. There will not be a secondary market for investments in the TALF Program. Thus, investors should expect at least a three-to-five year lockup period. This lack of liquidity will necessitate that any assets dedicated to the Program will have to be separate from the other, more liquid, assets of the investor when determining strategic allocation decisions. However, with approval of the FRBNY, TALF loans can be transferred with the collateral until December 31, 2009.
- Potential conflicts of interest are a major concern of the TALF Program. One potential conflict of interest is with rating agencies. Rating agencies play a critical role in the management of this Program due to the fact that the assets must be AAA-rated by at least two rating agencies. Leading up to and during the crisis, the ratings agencies proved to be less than reliable. While the rating agencies are revising their procedures to address their crisis-related failures, any rating by the rating agencies should be viewed with a healthy amount of skepticism and independent due diligence should be conducted by the



investment manager. Thus, it will be vitally important for the asset manager to be able to accurately analyze and price the underlying collateral. Another potential conflict of interest arises with the investment managers. Asset managers have large incentives to promote and sell their TALF products. As a result, many investment manager sponsors of TALF funds have likely downplayed the potential risks involved with the Program.

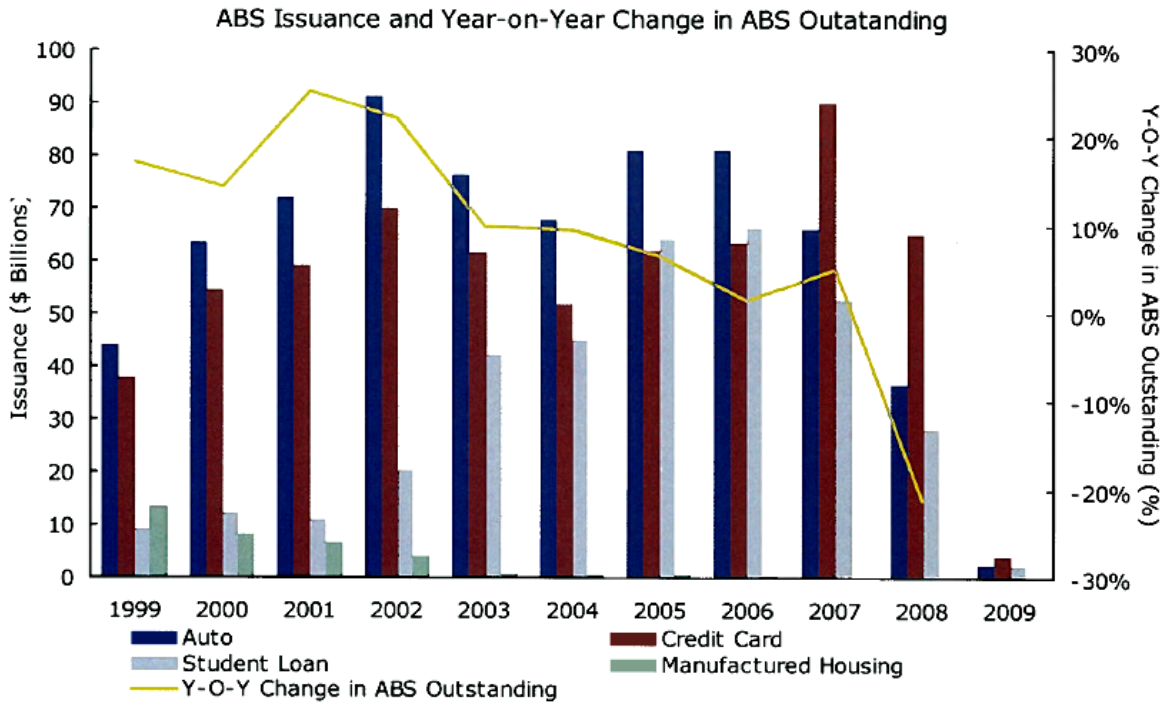
- Mismatch of cash flows. Another potential concern that may arise from an investment in the Program is the mismatch of cash flows between the investment collateral and commensurate TALF loan(s). Even if the investment manager correctly matches maturity/duration between the collateral and the TALF loans the possibility that payments of the two cash flow streams may be different. Interest is payable monthly on the TALF loans while there is no guarantee that the interest earned on the collateral will be paid monthly. It could be paid quarterly, semi annually or annually.
- Portfolio Concentration. Due to the currently limited issuance of new-issue ABS under TALF, the opportunity to construct a diversified portfolio of ABS collateral is limited. Thus far new issuance of ABS has been concentrated in only a few auto and credit card oriented issuers. This lack of issuer breadth could limit diversification and could lead to concentration risk. At this time, the limited volume of new issuance impacts portfolio asset allocation to a greater degree than the investment manager discretion.

## **Background Information on the TALF Program**

On November 25, 2008 the Federal Reserve Board announced the Term Asset-Backed Securities Loan Facility (TALF), a facility designed to help market participants meet the credit needs of households and small businesses by supporting the issuance of asset-backed securities (ABS) collateralized by student loans, auto loans, credit card loans, loans guaranteed by the Small Business Administration (SBA), and commercial mortgage backed securities (CMBS). Under the TALF, the Federal Reserve Bank of New York (FRBNY) plans to lend up to \$200 billion on a non-recourse basis to holders of certain AAA-rated ABS backed by newly and recently-originated consumer and small business loans. The FRBNY will lend an amount equal to the market value of the ABS less a haircut and will be secured at all times by the ABS. The U.S. Treasury Department, under the Troubled Assets Relief Program (TARP) of the Emergency Economic Stabilization Act of 2008, will provide \$20 billion of credit protection to the FRBNY in connection with the TALF. The U.S. Government developed the Program in response to a freezing up of credit markets following the bankruptcy of Lehman Brothers. New issuance of ABS declined precipitously in September 2008 and came to a halt in October (see chart below). At the same time, interest rate spreads on AAA-rated tranches of ABS soared to levels well outside the range of historical experience, reflecting unusually high risk premiums. The ABS markets historically have funded a substantial share of consumer credit and SBA-guaranteed small business loans.



### Securitized Lending Trends



Source: Pimco & JP Morgan  
As of February 28, 2009

Continued disruption of these markets could significantly limit the availability of credit to households and small businesses and thereby contribute to further weakening of U.S. economy. The TALF is designed to increase credit availability and support economic activity by facilitating renewed issuance of consumer and small business ABS at more normal interest rate spreads.

#### Program Structure

Under the TALF Program, the Federal Reserve Bank of New York will provide non-recourse funding to any eligible borrower (investment manager) owning eligible collateral. On a fixed day each month, borrowers will be able to request one or more three-year TALF loans. Loan proceeds will be disbursed to the borrower, contingent on receipt by the FRBNY's custodian bank of collateral deemed eligible by the FRBNY. As the loan is non-recourse, if the borrower does not repay the loan, the FRBNY will enforce its rights in the collateral and sell the collateral to a special purpose vehicle (SPV) established specifically for the purpose of managing such assets. The amount loaned by the FRBNY for each TALF loan equals the market value of the collateral minus a haircut. The loans have a three-year term in most cases. However, TALF loans collateralized by a CMBS or student loan ABS could have a three-to-five year maturities, at the election of the borrower. TALF loans are pre-payable without penalty at the option of the borrower, but substitution of collateral during the term of the loans is not permitted. Any remittance of principal on collateral must be used immediately to pay down principal of the TALF loan. Borrowers will be able to pick either a fixed or floating interest rate on the loans.