

Term Asset-Backed Securities Loan Facility

Hedge Funds Gain Access to Government Loans as Fed Expands the TALF

By Jennifer Banzaca

Hedge funds find themselves in new territory under a plan by the Federal Reserve to boost lender liquidity. The Fed created a new \$200 billion lending facility, called the Term Asset-Backed Securities Loan Facility (TALF), which offers low-cost, three-year financing to a wide range of US banks and investors for the purchase of securities backed by consumer loans, beginning in February 2009. Notably, domestic (though probably not offshore) hedge funds would be eligible to participate in the program, allowing them to borrow from the Federal Reserve, something hedge funds have not been able to do in the past.

The asset-backed securities (ABS) market has been not performed well in recent months, with new issuance essentially grinding to a halt by October and spreads on ABS over Treasuries continuing to widen. According to Thomson Reuters, U.S. ABS issuance fell 82% to \$159.8 billion in 2008, compared with \$898 billion sold in 2007. As a result, investors in ABS have seen higher risk premiums as banks have scaled back on the types of loans that typically back ABS, except to the lowest-risk borrowers.

As a result of the generally frozen credit markets – for consumers as well as corporate and investment fund borrowers – TALF funds are likely to have broad appeal. “There just isn’t a lot of credit available to any investor right now,” noted Mitchell Nichter, a partner at law firm Paul Hastings. “Looking at the current economic and financial realities, I think these facilities will be of interest to anyone

investing in these securities, not just hedge funds. I think that on a very basic level, anyone – not just hedge fund managers – might have a bit of reluctance in dealing with a governmental entity. But, I think the economic and financial realities will overwhelm that concern. If credit is needed and the terms of the credit available for this facility make economic and financial sense to a hedge fund manager, I think they’ll participate.”

TALF Terms

Under the TALF, the Federal Reserve Bank of New York will provide non-recourse funding to any eligible borrower owning eligible collateral. The TALF will finance only certain newly issued, highly rated ABS collateralized by student loans, auto loans, credit card loans and loans guaranteed by the Small Business Administration.

The eligible ABS must be issued on or after January 1, 2009 and all or substantially all of the underlying credit exposure for eligible auto loan ABS must have been originated on or after October 1, 2007. Eligible credit card ABS must be issued to refinance existing credit card ABS issued in 2009, the Fed said.

The purpose of the TALF, as explained by the Fed in a statement, is “to increase credit availability and support economic activity by facilitating renewed issuance of consumer and small business asset-backed securities. The

ABS markets historically have funded a substantial share of consumer credit and SBA-guaranteed small business loans, but conditions in ABS markets have caused issuance of such securities to come to a standstill in recent months.”

TALF loans will be available on a fixed day each month. The minimum loan size under the TALF will be \$10 million. The US Treasury Department will provide \$20 billion of credit protection to the Federal Reserve in connection with the loan facility, the Fed said in a press release. The facility will not allow for the substitution of collateral.

The three-year, non-recourse loans are prepayable and available with either a fixed or floating interest rate. Nichter said that given the shorter term and probably higher rates of the credit facilities available from other lenders, the terms of the TALF loans could make the lines of credit that much more enticing to hedge funds and other investors. Sweetening the deal could be broadening the eligible collateral to include new commercial and residential mortgage-backed securities.

“The Fed has indicated that at some point it may consider expanding the universe of eligible collateral to include, for example, real estate and mortgage-backed securities that would be of tremendous interest to hedge fund managers,” Nichter added.

Why Take Advantage of the TALF?

Victor Zimmermann, vice chair of the international funds group at Curtis, Mallet-Prevost, Colte & Mosle, said that as prime brokers have clamped down on credit availability, it

would make sense for hedge funds to take advantage of any credit that is available to allow them to make and leverage investments.

“One problem for a lot of funds has been that some of the credit lines have been pulled or cut back and that in turn has forced a lot of selling on behalf of the funds,” Zimmermann stated. “A lot of their strategies depend on leverage so the availability of credit in general is appealing.”

Another attraction for hedge funds is that the government funding would be a more permanent capital base than a facility from a prime broker because under most prime brokerage agreements, a prime broker has significant latitude in withdrawing credit whereas the government facility is stable for the duration of the loan, Zimmermann added.

Nichter noted that another advantage for hedge funds accessing TALF loans is the duration of the loan – three years, which he said is a relatively long term in today’s credit environment.

Yet another key reason hedge funds may consider taking advantage of the TALF is that the Federal Reserve will not require a constant marking to market of the collateral, Nichter explained. “The government is not going to be in a position to make margin calls on the borrowers,” Nichter said. “In the past six months there have been quite a few hedge fund managers that have been margin called to death. This would be a big advantage for anyone, not just hedge funds.”

Will Hedge Funds Access the TALF?

While there are advantages to applying for a TALF loan, Ben Shoval, managing director at hedge fund Ambit Funding, does not think that many hedge funds will use the TALF. More traditional, low-return investors such as insurance companies are more likely to be interested in these facilities, Shoval said.

According to Shoval, one reason hedge funds may steer clear is that even when there was an active market in ABS, their meager returns meant that they were only a sensible investment for hedge funds using some degree of leverage. Even with the TALF, there may not be enough credit out there to justify a return to ABS. "Because so little leverage is available, it will be difficult for hedge funds to profit from them," Shoval noted.

Shoval added that hedge funds have assiduously avoided entanglement with the government and despite the seeming attractiveness of the TALF, the burden of association with the government may outweigh the benefit of credit.

However, despite the tight general credit environment and the government association, hedge funds may start applying for TALF loans if market conditions continue to deteriorate and ABS become available at a significant discount. "At that point, I could then see a hedge fund buying them and holding them with the expectation that they'll come back up in value or that they'll mature for the full value," Shoval explained. "This is pretty high quality stuff and for something that high quality to become that deeply discounted would be unlikely."

Despite Shoval's suggestion that hedge funds are unlikely to use the TALF, both Zimmerman and Nichter stated that

hedge funds that already invest and trade in the securities needed to collateralize the loans would likely be interested in the facility.

"If these facilities work out, they could have returns that are better than the market and it's the kind of thing that really appeals to a hedge fund manager," Zimmerman noted. "I'm sure the funds would compare this to any of the similar facilities they could get from other financial institutions and decide it could be a good investment."

Non-Recourse Loans

Another key incentive for participating in the TALF is that the loans will be non-recourse, meaning that if the collateral falls in value below the initial discount (the government will only lend up to a certain percentage of the value of the collateral), the government – not the hedge fund borrower – will absorb any losses. Similarly, in the event of default, the government will enforce its rights to the collateral and sell it to a special purpose vehicle established specifically for the purpose of managing such assets. In effect, the Fed is acting in this capacity like a bond insurer.

The government, however, is not giving something for nothing. Since eligible collateral will only involve, at least initially, highly rated ABS that is unlikely to default, the government is not expected to experience many "claims," as it were, on its "bond insurance." And the returns on such highly rated paper are not expected to be profound, even in the presence of some leverage. Given the labor involved in any investment, especially one with a government partner, the advisability of TALF loans is likely to remain context-specific.