Clients&FriendsMemo

COVID-19 Update: Federal Reserve Provides Additional Guidance on Inclusion of CLOs in New TALF Term Sheet and Responses to Frequently Asked Questions

May 13, 2020

As part of a number of liquidity measures announced in response to the COVID-19 pandemic, the Federal Reserve re-established the Term Asset-Backed Securities Loan Facility ("TALF") on March 23, 2020. On April 9, 2020, the Federal Reserve released an updated term sheet that expanded the range of "eligible collateral" to include certain legacy commercial mortgage-backed securities and newly-issued, static collateralized loan obligations ("CLOs") and clarified which businesses would qualify as "eligible borrowers."[1]

On May 12, 2020, the Federal Reserve released another update to the term sheet for the TALF program.[2] In addition, the Federal Reserve issued guidance in response to frequently asked questions ("FAQs").[3] This memorandum reviews the changes contained in the new term sheet and summarizes some of the key takeaways from the FAQs regarding the inclusion of CLOs as "eligible collateral" for TALF loans.

Eligible CLO Securities

U.S. dollar-denominated securities issued by static CLOs that are collateralized by leveraged loans[4] must satisfy the following criteria in order to qualify as eligible collateral for a TALF loan:

Static CLOs. TALF-eligible CLOs must be backed by a fully-ramped, static pool of leveraged loans. A static CLO for purposes of TALF has the following characteristics:

- *Limited Reinvestment*. TALF-eligible CLOs will be required to limit the reinvestment of any proceeds (interest, principal, sale, prepayments, etc.) in additional leveraged loans

[1] Available at https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200409a1.pdf

[2] Available at https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200512a1.pdf

[3] Available at https://www.newyorkfed.org/markets/term-asset-backed-securities-loan-facility/term-asset-backed-securities-loan-facility-faq

[4] CLOs backed by commercial real estate are not eligible collateral under TALF.

(a) unless such reinvestment occurs at least three years after the disbursement date of the related TALF financing and (b) at any time when the senior ABS of such CLO is owned[5] by the Federal Reserve Bank of New York ("FRBNY") or the TALF SPV.[6]

- *Sales Restrictions*. TALF-eligible CLOs will be required to restrict the sale of underlying loans other than loans:

  (a) that have defaulted in payment of principal and interest[7] or

  (b) that are sold "to a sponsor" [8] for an amount at least equal to par plus accrued.

  Note: *The concept of a defaulted underlying loan for purposes of TALF is significantly narrower than a typical CLO definition of "Defaulted Loan," which may be solved by using different defined terms to distinguish between defaulted assets for the purposes of permitted sales and applying haircuts.*

  Note: *Some uncertainty exists, based on the current language in the FAQ, whether sales of defaulted loans must also be sold "to a sponsor" for an amount at least equal to par, which, as a practical matter, would be problematic.*

  Note: *As currently proposed, TALF-eligible CLOs would not be permitted to sell "Credit Risk Loans" unless sold to a sponsor for an amount at least equal to par plus accrued.*

Issue Date. TALF-eligible CLO securities must be issued on or after March 23, 2020 and, unless the Board and the Secretary of the Treasury extend the facility, on or before September 30, 2020.[9]

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[5] Note that such ownership would not be expected to occur absent foreclosure by the FRBNY or the TALF SPV or, if applicable, collateral surrender by the borrower.

[6] Combined with the requirement that the portfolio of underlying collateral be fully-ramped, this effectively means that a TALF-eligible CLO will be restricted from purchasing any additional loans following the date of issuance until the termination of the related TALF financing.

[7] Note that, as currently proposed in the FAQs, the sale of a loan that has defaulted in payment of interest would not be permitted by a TALF-eligible CLO issuer until the maturity of the loan had been accelerated.

[8] The term "sponsor" is not defined in the FAQs.

[9] In addition, the FAQs state that if the ABS securing the financing is not issued on the same day as the financing, such ABS must have been acquired in an arms-length secondary market transaction within 30 days prior to the relevant loan subscription date. While not explicitly stated, ABS acquired by a TALF borrower in the primary market should also be eligible collateral for a TALF loan subscribed for within 30 days of the ABS issuance, if the ABS satisfies all other eligibility criteria.

Rating. TALF-eligible CLO securities must be triple-A rated by at least two of S&P, Moody's and/or Fitch.[10,11]

CLO Manager. The manager of a TALF-eligible CLO must have its principal place of business in the U.S.

Interest Payments. Interest payments of TALF-eligible CLO securities:

- may not step-up or step-down; and
- may be benchmarked to LIBOR, but then must include adequate fallback provisions (such as the recommended Alternative Reference Rates Committee ("ARRC") fallback language or substantially similar fallback language).

Maturity. There is no minimum or maximum maturity limit for TALF-eligible CLO securities.

Average Life. The average life of TALF-eligible CLO securities cannot be greater than ten years.

> ***Note**: The average life will be determined based on the weighted average life to maturity assuming a 10% conditional prepayment rate.*

> ***Note**: Issuers of TALF-eligible CLO securities will be expected to disclose the average life of the ABS in the offering document. The FAQs state such disclosure is material to and will be relied on by the FRBNY, introducing potential liability to the CLO issuer.*

Redemptions. TALF-eligible CLO securities may not be callable by the CLO issuer prior to the three year anniversary of the disbursement date of the related TALF loan (and never when the ABS is owned by the FRBNY or the TALF SPV),[12] other than pursuant to a customary clean-up call.[13]

> ***Note**: The limit on redemptions of TALF-eligible CLO securities appears to prohibit (a) a non-call period of less than 3 years and (b) tax redemptions inside the 3-year non-call period. The FAQs*

[10] "Eligible collateral (eligible ABS) include U.S. dollar-denominated cash (that is, not synthetic) ABS that (i) have a credit rating in the highest long-term or, if no long-term rating is available, the highest short-term investment-grade rating category from at least two eligible ("NRSROs") and (ii) do not have a credit rating below the highest investment-grade rating category from an eligible NRSRO."

[11] The Fed may consider including other NRSROs under the TALF.

[12] Note that such ownership would not be expected to occur absent foreclosure by the FRBNY or the TALF SPV or, if applicable and permitted, collateral surrender by the borrower.

[13] "A "customary clean-up call" with respect to a sponsor and its securitization refers to the clean-up call which is exercisable by the servicer or the depositor when the remaining balance of the assets or the liabilities of the issuer is not more than 10% (or a higher percentage customarily used by the sponsor in its securitizations that were offered before the TALF program was established) of the original balance of such assets or liabilities." Relying on the alternative contained in the parenthetical, a 15% clean-up call may be permissible for TALF-eligible CLO securities.

do, however, permit clean-up call redemptions and appear to permit partial redemptions by refinancing of CLO tranches that are not otherwise TALF-eligible. TALF-eligible CLO securities may not be re-priceable prior to the end of the 3-year non-call period, because the issuer's customary right to compel a holder that doesn't agree to a re-pricing to sell its ABS seems incompatible with the restrictions on redemptions of TALF-eligible ABS.

Overcollateralization Test. TALF-eligible CLOs must include at least one overcollateralization test redirecting cashflow from the equity and subordinated tranches to the TALF-eligible senior tranche in the event of deterioration in the underlying loan portfolio.

DTC Clearance Required. TALF-eligible CLOs must be cleared through the Depository Trust Company.

Underlying Portfolio Requirements

Collateral Composition.

- *U.S. Origination*. For TALF-eligible CLOs, at least 95 percent of the dollar amount of the underlying loans of such CLO must be exposures that are (1) arranged by a lead or a co-lead arranger that is a U.S.-organized entity (including a U.S. branch or agency of a foreign bank) and (2) made to U.S.-domiciled obligors.

  ***Note**: The inclusion of U.S. branches or agencies of foreign banks appears to be responsive to industry feedback.*

- *Newly-Originated*. Not less than 95% of the eligible leveraged loans underlying a TALF-eligible CLO must have been newly-originated or refinanced on or after January 1, 2019.

  ***Note**: The origination date requirement appears to be responsive to industry feedback and should, subject to the satisfaction of the other eligibility criteria, make it possible to securitize certain legacy warehouse assets in TALF-eligible CLOs.*

- *Senior Secured*. All eligible leveraged loans underlying a TALF-eligible CLO must be senior secured (meaning first-lien, or subject to the limitation below, second-lien) and current on interest and principal.

- *Concentration Limitations*. TALF-eligible CLOs must satisfy the following portfolio limitations as of the financing subscription date:

  - not more than 10% may consist of second lien loans;

- not more than 7.5% may consist of debtor-in-possession (DIP) loans;
- not more than 65% of the underlying loans of a broadly syndicated CLO[14] and not more than 10% of the underlying loans of a middle-market CLO[15] may consist of covenant lite loans; and
- not more than 4% may consist of the obligations of a single obligor.

> ***Note**: The bifurcated limit on covenant lite loans, combined with the definitions of "broadly syndicated CLO" and "middle market CLO," effectively restricts TALF-eligible broadly syndicated CLOs from purchasing small obligor loans (less than $150,000,000 total potential indebtedness).*

- *Delayed Draw Loans*. Eligible leveraged loans do not appear to include delayed draw loans.

> ***Note**: The FAQs separately (a) restrict the retention of issuance proceeds in anticipation of application to the purchase of additional receivables and (b) clarify that the origination date of loans "drawn under an existing arrangement to extend credit" is the date on which the loan was drawn or funded and not the date on which the arrangement was put in place.*

- *TALF Borrower Affiliated Loans*. TALF-eligible CLO securities may not be backed by loans originated or securitized by the borrower or an affiliate[16] of the borrower.

> ***Note**: This is a particularly noteworthy limitation on manager/originators of middle market CLOs.*

Other Underlying Portfolio Requirements and Restrictions.

- Eligible leveraged loans underlying a TALF-eligible CLO that bear interest "tied to LIBOR are generally expected to have adequate fallback language" (such as the ARRC-recommended fallback language or substantially similar fallback language as prevailing in the relevant market when the loan was originated).

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[14] "A broadly syndicated CLO is a CLO that **does not** include leveraged loans of obligors with potential indebtedness of less than $150,000,000 and permits no more than 10% of the portfolio to be comprised of leveraged loans to obligors with total potential indebtedness of $150,000,000 to $250,000,000." (emphasis added)

[15] "A middle market CLO is a CLO that is composed of leveraged loans of obligors, **all or substantially all of which** have potential indebtedness of less than $250,000,000 but does not permit the portfolio to include leveraged loans of obligors with EBITDA (as calculated in accordance with the underlying instrument) of less than $10,000,000." (emphasis added)

[16] The term "affiliate" will have the meaning set forth in the Master Loan Security Agreement ("MLSA"). The MLSA relating to the current TALF program has not yet been published.

TALF Financing Terms

Financing of TALF-eligible CLO securities will be made on the following terms:

- Haircuts.[17] 20% if the average life of the CLO is five years or fewer;
  21% if the average life of the CLO is between five and six years;
  22% if the average life of the CLO is between six and seven years;.
  23% if the average life of the CLO is between seven and eight years;
  24% if the average life of the CLO is between eight and nine years;
  25% if the average life of the CLO is between nine and ten years;

- Financing Interest Rate. For CLOs, the interest rate will be 150 basis points over the 30-day average Secured Overnight Financing rate (30-day average SOFR), payable quarterly.

> ***Note**: Tying the TALF financing interest rate to 30-day average SOFR creates some basis risk for TALF borrowers, both at the outset and following the eventual transition from LIBOR.*

Additional Resources

Cadwalader "TALF 2.0: Overview and Opportunities" webinar, April 30, 2020

Cadwalader Clients & Friends Memo, "COVID-19 Update: Federal Reserve Launches TALF (Again)," March 23, 2020

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[17] Haircuts are subject to revision should market conditions change materially.

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