ALLEN & OVERY

Covid-19 coronavirus:

Updates to the Fed's 2020 TALF Program and their implication for the CLO market

Introduction

On May 12, 2020, the Federal Reserve Bank of New York (the "**Federal Reserve**") released a revised term sheet (the "**Term Sheet**")[1] for a new iteration of the Term Asset-Backed Securities Lending Facility ("**TALF**") and related responses to Frequent Asked Questions ("**FAQs**")[2].

TALF was established to "help facilitate the issuance of asset-backed securities (ABS), stabilize ABS markets, and support the availability of credit to households and businesses" since "in the days prior to the initiation of the program, there was a significant rise in the interest rate spreads on ABS, including on ABS traded in the secondary market, and new issuance in many ABS sectors nearly halted."[3] Eligible borrowers under the TALF program can obtain financing from the Federal Reserve on a non-recourse basis (other than in the event of a breach of representation, warranty or covenant).[4] As described in the FAQs, "if the borrower does not repay the loan, the TALF SPV will enforce its rights in the collateral."[5] This feature provides TALF borrowers with what is effectively risk-free financing (subject to the applicable haircut described below and potential liability in respect of a breach of a representation, warranty or covenant, as noted above) to buy eligible asset-backed securities ("**ABS**"), including "AAA" rated collateralized loan obligation ("**CLO**") securities.

The Term Sheet clarified some key questions left unanswered in an earlier version of the term sheet released in April (the "**April Term Sheet**"), and such revisions may create meaningful opportunities for banks to monetize existing CLO warehouse exposure on their balance sheets, and to consequently free-up funds for other lending activities encouraged by TALF; for direct lenders who use CLOs (and in particular, middle market CLOs) as a vehicle to finance their business activities to incentivize their "AAA" investors to invest in their CLOs in the current economic environment; and for managers, investors and market intermediaries who, as a result of their particular circumstances in the current economic environment, would find it attractive to participate in CLOs that are structured to comply with the strict terms of the TALF program. However, as described below, the TALF terms contain some fundamental differences from ordinary course CLO transactions. Accordingly, there remain several points in need of clarification or revision which might

1 Available at https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200512a1.pdf.

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

3 Federal Reserve Bank of New York. FAQs: Term Asset-Backed Securities Loan Facility. "For the purposes of participating in the TALF, what does it mean for a TALF borrower to certify that it is unable to secure adequate credit accommodations?" May 12, 2020.

4 The FAQs note that this exception will be further specified in the Master Loan and Security Agreement that will apply to all loans issued under the TALF program.

5 The Federal Reserve will set up a special purpose vehicle (the "TALF SPV") to provide funding to TALF borrowers. See Federal Reserve Bank of New York. FAQs: Term Asset-Backed Securities Loan Facility. "How will the TALF work?" May 12, 2020.

otherwise limit the intended utilization of TALF by active participants in the CLO market. Described below are key provisions in the Term Sheet and FAQs as they relate to CLOs.

What qualifies as eligible CLO collateral under TALF ("Eligible Collateral")?

Unlike the 2008 TALF program, the Federal Reserve expanded TALF to include CLOs as eligible collateral.

Eligible Collateral must be a static CLO that cannot permit reinvestment of principal or interest proceeds for three years after the issue date of the TALF loan or so long as the Federal Reserve or the TALF SPV own the CLO collateral. Participants may want to consider structuring TALF-compliant CLOs to provide for "springing" reinvestment periods that would come into effect upon the earlier of such three-year period and the prepayment in full of the applicable TALF loan.

Sales of defaulted obligations are permitted, if, according to the FAQs, the obligor has defaulted on the payment of "principal and interest".[6] It should be noted that the FAQs use the conjunctive "and" rather than the disjunctive "or" in describing a default in the payment of "principal and interest", which provides some ambiguity as to whether the intent is truly to require both principal and interest defaults in order to satisfy this criterion. The criterion for defining a defaulted obligation described in the FAQs is also significantly narrower than the customary definition of a defaulted obligation in ordinary course CLOs, as CLO documentation typically includes multiple grounds for classifying an obligation as a defaulted obligation, including a payment default on principal or interest, acceleration by lenders following any other type of default under the underlying loan documents, cross-defaults, insolvency proceedings and ratings downgrade triggers. Static CLOs also typically permit sales of credit risk obligations (i.e., loans that in the judgment of the collateral manager have a significant risk of declining in credit quality or becoming defaulted obligations), which is not expressly permitted under the current version of the Term Sheet or FAQs. Moreover, TALF permits the sale of loans to a "sponsor", so long as the sale price is at par plus accrued interest. The term "sponsor" is not defined in the Term Sheet or the FAQs, and its usage seems misplaced here, as it is not used in any similar context elsewhere in the Term Sheet. A possible reading could be that loans are permitted to be repurchased by the parent/seller/contributor (perhaps, due to a breach of a representation or warranty) in middle market or other balance sheet CLOs, but this would preclude any such sales or repurchases for open market (including most broadly syndicated loan ("**BSL**")) CLOs, which constitute approximately 90% of the CLO market. It is also not clear why a sale to third-party would not be permitted, since there is economic protection in the requirement that the sale price be at par plus accrued interest.

Importantly, Eligible Collateral cannot permit an optional redemption (other than customary clean-up call redemptions) for a period of three years from the issue date of the TALF loan or for so long as the Federal Reserve or the TALF SPV own the CLO collateral. Participants aiming to utilize TALF may want to consider structuring the non-call period to account for any extensions in the TALF program and to provide that redemption rights would be triggered on an earlier date (e.g., two years from the CLO closing date) in the event that the applicable TALF loan has been repaid in full. While the Term Sheet and the FAQs do not explicitly mention re-pricings or other methods of effectively "refinancing" the interest rate on the CLO notes (such as Applicable Margin Reset (AMR) auction mechanics), it is doubtful that the Federal Reserve intended to permit such actions during the term of the applicable TALF loan given the prohibition on optional redemptions. However, the fact that TALF loans may be prepayable at any time in whole or in part by the borrower begs the question of why there is a need to restrict optional redemptions of the ABS securities in the first place? Presumably, the TALF SPV would be fully protected by the customary provision in CLOs that requires the proceeds of optional redemptions to be sufficient to repay the redeemed notes in full.

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[6] Federal Reserve Bank of New York. FAQs: Term Asset-Backed Securities Loan Facility. "Are sales of defaulted underlying assets permissible for eligible CLOs?" May 12, 2020.

The Term Sheet also clarifies that while the special purpose vehicle issuing Eligible Collateral need not have any particular domicile, only CLOs with collateral managers that have their principal place of business in the United States will constitute Eligible Collateral.

Other requirements include:

– Eligible Collateral must be rated by at least two of S&P, Moody's and Fitch.[7] (It should be noted that ordinary course static CLOs are typically rated by only one such rating agency.)
– Eligible Collateral cannot be on review or watch for downgrade (although there is no effect to existing TALF loans already secured by downgraded Eligible Collateral).
– The stated maturity of Eligible Collateral cannot exceed 10 years.
– Eligible Collateral cannot have interest step-up or step-down to pre-determined levels on specific dates.
– Eligible Collateral linked to a LIBOR rate is expected to have ARRC or prevailing market fallback language.
– Eligible Collateral must be issued in global form and cleared through DTC.

What qualifies as eligible underlying credit exposures?

In order to be Eligible Collateral, the underlying credit exposures in the CLO portfolio must satisfy several requirements, including that at least 95% of the underlying credit exposures in the CLO portfolio must have a lead or co-lead arranger that is a U.S. organized entity (which also includes a U.S. branch or agency of a foreign bank) and at least 95% of the underlying credit exposures must have been originated (or refinanced) on or after January 1, 2019.[8] With respect to loan refinancings, participants will need to pay particular attention to the form in which such refinancings are documented, as existing loans that have undergone a material amendment or a re-pricing, but have not been re-documented as new loans, may not qualify as refinancings for purposes of determining its date of origination to be after such cut-off date.

The FAQs also state that Eligible Collateral "must not be backed by loans originated or securitized by the [TALF] borrower or by an affiliate of the [TALF] borrower".[9] Strictly speaking, this appears to restrict direct lenders from pledging to TALF CLO notes backed by loans where the lender acted as originator. There is also a question as to whether this would restrict banks that arrange CLOs backed by loans where the bank also participated in the origination and syndication of some of the underlying credits as agent from becoming TALF borrowers secured by such CLOs. To the extent this fact pattern is applicable to a transaction, participants should consider raising this concern with the Federal Reserve prior to making the necessary certifications and representations required of a TALF borrower. The level of certainty and comfort that a TALF borrower has regarding its ability to make the necessary representations and certifications is critical, since (as noted above) the TALF loan is made with recourse to the TALF borrower only in the event of a breach of a representation, warranty or covenant.

Other requirements relating to underlying credit exposures include:

– Certain concentration limits must be in the CLO documentation, including:
  – At least 95% U.S. domiciled obligors.
  – No more than 10% second lien loans.
  – No more than 7.5% DIP loans.
  – No more than 65% (for BSL CLOs) and 10% (for middle-market CLOs) cov-lite loans.[10]

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7 The FAQs note that the Federal Reserve may consider adding additional NRSROs in the future.

8 The FAQs consider 95% or more to qualify as "all or substantially all" in the contexts of determining whether (i) all of the underlying credit exposures are newly issued and (ii) the underlying assets in a newly issued CLO are arranged by a lead or a co-lead arranger that is a U.S.-organized entity and made to U.S.-domiciled obligors. See Federal Reserve Bank of New York. FAQs: Term Asset-Backed Securities Loan Facility. "What does 'all or substantially all' mean in the context of determining whether the underlying assets in a newly issued CLO are (1) arranged by a lead or a co-lead 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?" May 12, 2020.

9 Federal Reserve Bank of New York. FAQs: Term Asset-Backed Securities Loan Facility. "Can a company that originates loans securitize its own loan originations, acquire the triple-A-rated tranche of the securitization, and finance it using the TALF?" May 12, 2020.

10 The FAQs include the more flexible manager-friendly version of the Cov-Lite Loan definition that is prevalent in the CLO market over the last several years.

  - No more than 4% of a single obligor.
- All underlying credit exposures must be current on principal and interest payments.
- If the underlying credit exposures are linked to a LIBOR rate, they are expected to have ARRC or prevailing market fallback language.
- There must be at least one overcollateralization ratio test that diverts cash from the lowest priority tranches to the senior-most tranche.
- No more than 4% of the underlying credit exposures can be to obligors that are affiliated with the TALF borrower.

Who qualifies as an eligible TALF Borrower?

TALF borrowers must be United States companies (which includes a U.S. branch or agency of a foreign bank) that have an account with a TALF Agent.[11] If the TALF borrower is an investment fund, its investment manager must be based in the United States. No material investor (i.e., a person "who owns, directly or indirectly, 10 percent or more of any outstanding class of securities") in the TALF borrower (or investment fund manager of the TALF borrower) may be a foreign government. This creates an ongoing obligation for the TALF borrower to monitor its direct and indirect investors so long as the TALF loan is outstanding. The TALF borrower is also required to certify that it is "unable to secure adequate credit accommodations from other banking institutions"[12] and that it is not insolvent. The FAQs specify that "[L]ack of adequate credit does not mean that no credit is available. Lending may be available, but at prices or on conditions that are inconsistent with a normal, well-functioning market."[13] There remain questions as to what this certification entails for a TALF borrower. When read literally, this would require the TALF borrower itself to attest that it is unable to obtain such other adequate credit accommodations. However, this reading presupposes that the TALF borrower requires funding in order to purchase Eligible Collateral. The purpose of TALF is not to provide liquidity to TALF borrowers; rather, "TALF is designed to increase credit availability for businesses and consumers by facilitating the issuance of ABS backed by loans to consumers and businesses at more normal interest rate spreads"[14] which is necessitated by the "market dislocations in the ABS markets"[15]. When read in the context and the spirit of this policy, a rational interpretation with a view to maximizing this policy's intended purpose could be that the appropriate certification from the TALF borrower should point to the ABS issuer (as the credit-seeker and intended recipient of the support of the TALF program) as the entity that is in fact structured to extend credit to businesses and which is unable to obtain such other "adequate credit accommodations from other banking institutions" However, we note that there is no express language in the Term Sheet or the FAQs that supports the conclusion that such certification can relate to the ABS issuer's (and not the TALF Borrower's) ability to obtain credit, and accordingly we caution that such conclusion may not be definitively relied on without further guidance from the Federal Reserve. Furthermore, if the TALF borrower is required to certify that it cannot obtain adequate credit accommodations, it could lead to unintended consequences as it may require TALF borrowers to obtain pricing quotes from other banking or other financial institutions prior to utilizing TALF. The FAQs indicate that borrower certifications with more detailed instructions will be forthcoming.

Interest Rate, Fees and Other Key Commercial Terms

The interest rate on the TALF loan is 150 basis point over the 30 day average SOFR rate.[16] Interest on the TALF loan is payable quarterly. There is also an upfront administrative fee equal to 10 basis points of the

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11 The FAQs note that TALF Agents will initially consist of Primary Dealers. See Federal Reserve Bank of New York. FAQs: Term Asset-Backed Securities Loan Facility. "What is a TALF Agent?" May 12, 2020.

12 Federal Reserve Bank of New York. FAQs: Term Asset-Backed Securities Loan Facility. "What certifications or attestations will TALF borrowers be required to make?" May 12, 2020.

13 Federal Reserve Bank of New York. FAQs: Term Asset-Backed Securities Loan Facility. "For the purposes of participating in the TALF, what does it mean for a TALF borrower to certify that it is unable to secure adequate credit accommodations?" May 12, 2020.

14 Federal Reserve Bank of New York. FAQs: Term Asset-Backed Securities Loan Facility. "Is the TALF designed to provide loans directly to businesses or consumers?" May 12, 2020.

15 Federal Reserve Bank of New York. FAQs: Term Asset-Backed Securities Loan Facility. "For the purposes of participating in the TALF, what does it mean for a TALF borrower to certify that it is unable to secure adequate credit accommodations?" May 12, 2020.

16 Despite commentary from market participants that this pricing structure creates a reference rate mismatch with LIBOR-based CLOs, the Term Sheet is unchanged from the April Term Sheet in this respect.

principal amount of the TALF loan. The Federal Reserve also applies a haircut for CLOs beginning at 20% and up to 22%, depending on the CLO's average life.[17] The TALF program is available until September 30, 2020, unless it is subsequently extended.

Conclusion

While TALF (in its current form) may create some opportunities for banks to monetize their existing CLO warehouse lines, for direct lenders to incentivize their "AAA" investors and for managers, investors and market intermediaries to avail themselves of TALF-compliant CLOs as a result of their particular circumstances in the current economic environment, such opportunities are likely to be limited. The fact that Eligible Collateral must be static and have a three-year restriction on optional redemption (including refinancings), as well as the TALF loan pricing levels, punitive CLO haircuts (compared to other ABS asset classes) and uncertainty regarding the specifics of the TALF borrower certification requirements, are all likely to limit the utilization of TALF by traditional CLO market participants, particularly in the context of arbitrage BSL CLOs sold to third-party equity investors. Unless TALF is subsequently revised further to better accommodate the CLO market on these structural and economic terms[18], its impact on the CLO market is unlikely to be profound.

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17 Despite commentary from market participants that this level of haircut is significantly more punitive than that of other asset classes and that this does not appear to be justified based on the fact that AAA-rated CLO notes have historically never suffered a loss, the Term Sheet is unchanged from the April Term Sheet in this respect.

18 It should be noted that the revisions to the Term Sheet since the April Term Sheet are helpful and accommodating to the CLO market on some of the more nuanced points such as the Eligible Collateral look-back date and jurisdictional requirements.