

ONPOINT / A legal update from Dechert's Global Finance Group

CLOs and Term Asset-Backed Securities Loan Facility (TALF)— We're Not That Desperate (Yet)

As revised, TALF may provide a safety net in the event of catastrophic CLO market conditions, but is not likely to meet the goal of reviving the corporate loan market

Authored by Christopher Desmond, Christopher P. Duerden,
John M. Timperio, Mary Bear, Eric Evans and David Griffin

May 2020

Dechert
LLP



CLOs and Term Asset-Backed Securities Loan Facility (TALF)— We’re Not That Desperate (Yet)

As revised, TALF may provide a safety net in the event of catastrophic CLO market conditions, but is not likely to meet the goal of reviving the corporate loan market

Introduction

On May 12, 2020, the Federal Reserve Board of Governors (the “**Federal Reserve**”) and the Federal Reserve Bank of New York (“**New York Fed**”) released an updated term sheet (the “**New Term Sheet**”) for the Term Asset-Backed Securities Loan Facility (“**TALF**”) program and updated its FAQs on TALF (“**TALF FAQs**”), revising and clarifying the specifics of its April 9, 2020 term sheet.¹ Significantly, the New Term Sheet and TALF FAQs provided a number of clarifications and key additions applicable to collateralized loan obligation transactions (“**CLOs**”). Although eligible CLOs must be static, the definition of a “newly issued” leveraged loan was clarified to be any leveraged loan originated or refinanced on or after January 1, 2019, addressing a key concern from the prior term sheet. Another positive development was the clarification that the definition of eligible borrower (“**Eligible Borrower**”) under TALF will include investment funds so long as the investment manager of any such fund has significant operations in and a majority of its employees based in the United States.

Notwithstanding these clarifications (which demonstrate the Federal Reserve has a keen understanding of CLOs), the New Term Sheet continues to contain some short-comings vis-à-vis CLOs which will severely limit its utility other than as a backstop of last resort. For instance, the ability of TALF borrowers to make, and the diligence required to support, the certifications required under TALF (applicable to all TALF-eligible ABS, not just CLOs) are presently opaque and lacking developed market standards. Furthermore, the requirements that CLOs be static, have no effective redemption option within a three-year period and be subject to the highest haircuts and interest rates of any TALF-eligible ABS will further undercut the utility of the program in terms of facilitating the flow of credit to U.S. businesses through CLOs. Accordingly, we are continuing to work with industry groups and other law firms active in the CLO space to ameliorate these shortcomings through further guidance from the Federal Reserve.

Set forth below in this OnPoint is a more detailed analysis of the New Term Sheet and the considerations relevant for CLOs.

The Basics

Eligible CLOs. Pursuant to the New Term Sheet, a tranche of a CLO will be eligible as collateral for a TALF loan (an “**Eligible CLO**”) if it is a tranche of a U.S. dollar-denominated cash (*i.e.*, not synthetic) static CLO that: (i) has the highest credit rating from at least two eligible nationally recognized statistical rating organizations (“**NRSROs**”) (currently only S&P, Moody’s and Fitch); (ii) does not have a below investment-grade rating from an eligible NRSO;

¹ For a general description of the Fed’s announcement of the TALF Program, see the March 2020 *Dechert OnPoint - Federal Reserve Established Term Asset-Backed Securities Loan Facility (TALF)*. For a general description of the April 9, 2020 term sheet, see the April 2020 *Dechert OnPoint – Federal Reserve Releases Updated Term Sheet on the Term Asset-Backed Securities Loan Facilities (TALF)*. For a general description of the Updated Term Sheet, see the May 2020 *Dechert OnPoint - Federal Reserve Further Revises Term Sheet and Releases FAQ for the Term Asset-Backed Securities Loan Facility (TALF 2.0)*.

and (iii) is issued on or after March 23, 2020. Furthermore, Eligible CLOs must include at least one overcollateralization test.

Static Nature of CLOs. An Eligible CLO must be static and may not permit the buying or selling of underlying loans, subject to a few exceptions. Eligible CLOs may permit underlying loans to be sold for cash at their par amount, plus accrued interest, to a sponsor,² and defaulted loans may be sold regardless of price.³ In each case, however, the proceeds of such sales may not be reinvested and must be used to amortize the CLO.

Requirements Related to Underlying Loans of CLOs. All or substantially all⁴ of an Eligible CLO's underlying leveraged loans must: (i) be newly issued since January 1, 2019; (ii) have 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); (iii) be made to U.S. domiciled obligors;⁵ (iv) be broadly syndicated loans to large corporate borrowers ("BSLs") and/or middle market loans; (v) be current on principal and interest; and (vi) be senior secured. In addition, portfolios of Eligible CLOs are subject to certain concentration limitations (as described below) as of the subscription date.

Delineation of BSL versus Middle Market CLOs. As shown in the table below, the TALF FAQs define BSL CLOs and middle market CLOs in a way that generally aligns with existing definitions in the CLO market.

| | TALF FAQs | Existing CLOs |
|---------------------------|--|---|
| BSL CLOs | No obligors with potential indebtedness of less than \$150,000,000 No more than 10% of obligors with potential indebtedness of \$150,000,000 to \$250,000,000 | No obligors with potential indebtedness of less than \$150,000,000 Generally no more than 5% of obligors with potential indebtedness of \$150,000,000 to \$250,000,000 |
| Middle Market CLOs | All or substantially all obligors have potential indebtedness of less than \$250,000,000 No obligors with EBITDA of less than \$10,000,000 | All or substantially all obligors have potential indebtedness of less than \$250,000,000 Generally no obligors with EBITDA of less than \$10,000,000 |

Concentration criteria. The TALF FAQs set forth certain concentration limits for Eligible CLOs which, as shown by the table below, are generally favorable when compared to the concentration limits prevalent in the CLO market.

| | TALF FAQs | Existing BSL CLOs | Existing Middle Market CLOs |
|--------------------------|-----------|-------------------|-----------------------------|
| Second lien loans | ≤ 10% | ≤ 5% to 10% | ≤ 5% |

² This is a concept that will not exist other than in the case of some balance sheet CLOs such as middle market CLOs. This ability will be further circumscribed by bankruptcy true sale considerations.

³ Such sales (if they are to a seller/sponsor entity) could create true-sale concerns if such sales are made to affiliates, and thus will likely be limited due to such considerations.

⁴ The TALF FAQs clarify that "all or substantially all" means 95% of the principal balance of the underlying loans in the CLO.

⁵ Neither the New Term Sheet nor the TALF FAQs provide a definition as to what qualifies as a "U.S. domiciled" obligor, which may allow for such requirement to be satisfied in accordance with customary market practices.

| | TALF FAQs | Existing BSL CLOs | Existing Middle Market CLOs |
|---|--------------------------------------|---|---|
| Debtor in possession (DIP) loans | ≤ 7.5% | ≤ 7.5% to 10% | ≤ 5% |
| Covenant lite loans | ≤ 65% (BSL) ≤ 10% (Middle Market) | ≤ 60% to 70% | ≤ 12.5% to 15% |
| Single underlying obligor | ≤ 4% | ≤ 2% to 2.5% (with various exceptions for largest concentrations of obligors) | ≤ 2.5% (with various exceptions for largest concentrations of obligors) |

Restrictions on Affiliates. The program restricts a TALF borrower from obtaining TALF loans to fund its own or an affiliate's CLOs or in cases where the TALF borrower or an affiliate thereof is an obligor on more than 4% of the aggregate principal balance of the leveraged loans in the underlying loan portfolio.

Libor Fallback. As noted in the TALF FAQs, the underlying loans in Eligible CLOs with interest rates tied to LIBOR are generally expected to have adequate fallback language, which may be language recommended by ARRC or substantially similar fallback language (as prevailing in the relevant market when the loan was originated). While many leveraged loans do not currently contain ARCC or similar fallback language, the allowance for fallback language "prevailing in the relevant market when the loan was originated" may provide some flexibility in interpreting and satisfying this requirement.

Guidance on lead or co-lead arranger for underlying loans. The New Term Sheet clarifies that at least 95% of the principal balance of the underlying leveraged loans in a static CLO must have been 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).

The Positive

Several aspects of the foregoing criteria make TALF funds more accessible to the CLO market:

Clarification on "New Issue." The TALF FAQs state that "new issue" with respect to the underlying leveraged loans has been defined to include loans originated on or after January 1, 2019. The TALF FAQs clarify that this may include a leveraged loan that has been refinanced on or after January 1, 2019, even if such loan was originally closed on an earlier date. Defining "new issue" in this manner should allow for assets currently sitting in existing warehouses to serve as collateral in TALF eligible CLOs, which is critical given the short-tenor envisioned for the program itself.

Expansion of Eligible Borrowers. The TALF FAQs expand Eligible Borrowers to include borrowers created or organized in the United States as investment funds if the investment managers of such funds have significant operations in and a majority of employees based in the United States. An investment fund includes (1) any type of pooled investment vehicle that is organized as a business entity or institution, including without limitation a hedge fund, a private equity fund and a mutual fund, and (2) any type of single-investor vehicle that is organized as a business entity or institution. An investment manager of an investment fund will be considered to have "significant operations in the United States" if it has greater than 50% of its consolidated assets in, annual consolidated net income generated in, annual consolidated net operating revenues generated in or annual consolidated operating expenses (excluding interest expense and any other expenses associated with debt service) generated in the United States as reflected in its most

recent audited financial statements. The TALF FAQs clarify that the foregoing is not an exhaustive definition of what constitutes “significant operations in the United States.”

Clarification on CLO Issuers domiciliation. The New Term Sheet clarifies that eligible CLO issuers do not have to be originated by U.S. organized entities. Thus, CLO issuers can be Cayman domiciled, consistent with current market practice, provided that the manager of a CLO must have its principal place of business in the United States.

Interest payable quarterly. The TALF FAQs clarify that interest on TALF loans financing CLOs will be payable quarterly. As CLOs pay interest quarterly, this better aligns TALF loans backed by CLOs with the CLO market.

Weighted Average Life. Although the New Term Sheet limits the weighted average life of most TALF eligible collateral to five years, it allows a weighted average life of up to ten years for CLOs, calculated assuming a 10% conditional prepayment rate. A ten-year weighted average life should be more than adequate for the static CLO market, given that underlying first-lien loans generally have seven-year maturities.

Market covenant-lite definitions. As noted above, the TALF FAQs limit covenant-lite loans to 65.0% of the portfolio for BSL CLOs and 10% of the portfolio for middle market CLOs. In addition to the TALF FAQs allowing for concentration levels of covenant-lite loans that are generally consistent with the CLO market, the TALF FAQs define covenant-lite loan in a manner consistent with the more favorable CLOs in the market. The TALF FAQs define a covenant-lite loan as a senior secured loan that does not contain any financial covenants or maintenance covenants, but it provides an exception for loans that contain cross-default or cross-acceleration provisions to, or are *pari passu* with, another loan of the underlying obligor that does require a maintenance covenant or a financial covenant that applies only upon the occurrence of certain actions. Furthermore, a loan that does not have financial covenants or maintenance covenants only for a period of time after initial issuance or only for so long as there is no funded balance are not covenant-lite loans.

The Negative

Unfortunately, some of the TALF revisions related to CLOs create market impediments:

Redemptions. The TALF FAQs include a prohibition on ABS (and CLO) collateral in which the issuer has an option to redeem the CLO,⁶ exercisable prior to three years after the disbursement date of the related TALF loan, or at any time the ABS is owned by the New York Fed. (Only customary clean-up calls are carved out of this requirement.) This marks a change from the 2009 TALF program, under which the New York Fed would consider accepting ABS collateral with a redemption option exercisable at par. It also constitutes a significant impediment for the CLO market. Given that the underlying collateral is comprised of floating rate assets, equity investors typically demand the right to refinance or redeem the CLO debt after a two-year (or shorter in the case of static CLOs) non-call period to mitigate the effects of any material mismatch between the rates payable on the underlying CLO collateral and those payable on the CLO debt. Such a restriction may make it impossible to sell equity in a TALF eligible CLO. Furthermore, the goal of this restriction is unclear given that a TALF borrower has the ability to prepay a TALF loan secured by ABS (and CLO) collateral at any time prior to maturity. Accordingly, we believe that the approach taken in the 2009 TALF program (which did not so limit the redemptions) would be more consistent with the goal of protecting the loan made

⁶ It is unclear how this prohibition would apply to repricings or similar mechanics. The prohibition would not, however, apply to other classes of CLO debt that are not pledged to the New York Fed.

by the New York Fed while at the same time not unduly restricting the benefits of the program. We hope that this restriction is omitted in future updates.

Borrower Certifications. The TALF FAQs provide that an Eligible Borrower (pledging any ABS, not just CLOs) will be required to certify that it is (i) unable to secure adequate credit accommodations from other banking institutions and (ii) not insolvent. It is unclear how Eligible Borrowers will get comfortable making the clause (i) certification and whether Eligible Borrowers have to first request and be unable to obtain (or be unable to obtain on similar terms) financing from one or more financial institutions. Unfortunately, the TALF FAQs at present do not provide any guidance on this certification (which was not present in TALF 1.0), and market participants are presently struggling to ascertain the level of diligence that will be required to support such certifications. The TALF FAQs allude to further clarification in the forthcoming borrower certifications, but there can be no assurance that these concerns will be entirely resolved in such certifications.

It should also be noted that each Eligible Borrower also must certify that it is in compliance with the conflicts of interest requirements of section 4019 of the Coronavirus, Aid, Relief and Economic Security Act, which broadly relates to members of the administration, Congress and their relatives. Although it should not be problematic for most funds to make this certification, it remains unclear whether the certifications and indemnities that an Eligible Borrower is required to make could come from the issuer of a CLO. This is a critical distinction between CLOs and other ABS, as CLOs do not always have a clear “sponsor.”

Ratings Requirements. Eligible CLOs only include tranches that have the highest credit rating from at least two eligible NRSROs (currently only S&P, Moody’s and Fitch) and such tranches cannot have a below investment-grade credit rating from an eligible NRSRO. Currently, the prevailing market practice with respect to static CLOs (due to the nature of such transactions and cost constraints) is to obtain ratings from only one NRSRO.

Pricing and Haircut. For TALF loans financing Eligible CLOs, the interest rate will be 150 basis points over the 30-day average Secured Overnight Financing rate (30-day average SOFR).

The TALF haircuts are determined by asset class and the average life of the asset. Static CLOs with an average life from zero to five years have a haircut of 20% and this haircut will increase by 1% for each additional year of average life beyond five years. This haircut is higher than the haircut for other ABS asset classes and, as a general matter, high in relation to the credit risk posed by AAA rated CLO debt.

The pricing and haircut described above will potentially make TALF loans backed by CLOs uneconomic except in some limited cases, which would defeat a main purpose of the program. We hope that the pricing and haircut for CLOs improve in future updates.

Duration of TALF program. It is not expected that the TALF program will be fully operational before the middle to end of June 2020 and, unless the program is extended, no new TALF loans will be made after September 30, 2020. This September termination date will limit the ability of new CLO warehouses to access TALF funds given the time needed to build a portfolio with the diversity and other collateral quality characteristics to support the requisite rating. Although managers with pre-existing pools of qualifying loans may be able to arrange a CLO in time, a completely new CLO warehouse would typically require a warehousing period of three to six months, plus additional time needed for structuring and marketing a CLO. Furthermore, an Eligible CLO, as a static CLO, would not be able to continue to ramp after closing. We hope the duration of the program is extended at least until the end of 2020 to broaden the universe of Eligible CLOs which are able to participate.

Limits on Material Investors of Eligible Borrowers. An investment fund that borrows under TALF must not have any Material Investors (defined in the Q&A as a person who owns, directly or indirectly, 10% or more of any outstanding class of securities of an entity) that are foreign governments. This may preclude foreign state-run investment funds from investing into an Eligible Borrower, directly or indirectly. That said, as long as the Eligible Borrower satisfies the requirement that it be created or organized in the United States, it is presumably allowed for an Eligible Borrower to have a foreign parent as long as the parent is not a foreign government.

The Unknown

U.S. Obligors. As noted above, all or substantially all of leveraged loans underlying an Eligible CLOs must be issued to U.S. domiciled obligors. Neither the New Term Sheet nor the TALF FAQs define what qualifies as a “U.S. domiciled” obligor, which may allow for such requirement to be satisfied in accordance with customary market practices.

Material Modifications of Underlying Loans. The TALF FAQs clarify that for CLOs, underlying loans are “newly issued” if they are originated or refinanced on or after January 1, 2019. However, it is unclear whether this includes loans subject to material modifications on or after January 1, 2019, or whether a delayed draw or revolver portion of a loan made after January 1, 2019 would be allowed, even if the related loan closed prior to January 1, 2019.⁷

Scope of Defaulted Loans. As noted above, Eligible CLOs may permit defaulted loans to be sold for less than par. The TALF FAQs allow for sales of loans that are “defaulted in payment of principal and interest,” but fail to specifically include other types of defaulted loans, such as loans that have experienced non-payment defaults or loans to borrowers that have filed for bankruptcy. Including these types of loans as “defaulted loans” in CLO indentures helps protect the credit quality of the underlying CLO collateral pool. It is unclear if the Federal Reserve intended the reference to a loan that is “defaulted in payment of principal and interest” to be proscriptive or merely an example of a defaulted loan.⁸

Sales of Credit Risk or Equity. Similarly it is unclear whether credit risk sales or sales of equity received in a workout will be permitted in a static CLO. Not allowing such an ability would lead to a “water the weeds” approach to the underlying credits in such CLOs and prevent the CLO managers from protecting the CLO by disposing of such assets before they became defaulted.

Maturity Amendments. Furthermore, the New Term Sheet did not specify whether permitting a CLO to vote on maturity amendments for underlying loans would be consistent with a static CLO. These provisions are important tools available to CLO managers for the preservation of value in CLOs, particularly in this current economic environment (see our **COVID-19 Coronavirus Business Impact: CLO Indenture Update**).

Voting Rights. CLOs (unlike a number of other ABS asset classes) require the consent or direction of the controlling class for various modifications and other actions that a CLO issuer or its manager may take. Under TALF, the Eligible Borrower holding the senior notes will most likely be the controlling class in any CLO in which it invests, but it must

⁷ The TALF FAQs explicitly address delayed draw term loans with respect to other asset classes, but are silent on delayed draws with respect to CLOs.

⁸ CLOs typically define loans as defaulted if any of the following occur: (i) a default in payment of principal and/or interest; (ii) bankruptcy proceedings are commenced with respect to the obligor; (iii) a downgrade of the rating of the loan below certain levels; (iv) a default (other than a payment default) and acceleration under the underlying instruments; or (v) the CLO manager determines such loan to be defaulted in its commercially reasonable judgment.

agree not to exercise any voting rights without the consent of the New York Fed. It remains unclear how this restriction will work in reality, how timely any consents may be obtained (if at all), how other CLO investors will view having a government agency as their controlling class and what impact this will have on the pricing of the CLO's liabilities.

Moving Forward

The New Term Sheet represents forward progress in bringing the TALF program closer to being accessible to Eligible CLOs. Indeed, as it stands, the program is workable as a lender of last resort that could be used if the CLO markets become significantly more dislocated. It may also be useful for managers facing upcoming warehouse terminations who have no other options for a CLO take-out, even if the terms of complying with the Eligible CLO restrictions are less than optimal. However, more progress needs to be made for the program to revive corporate loan issuance. Based on the understanding and knowledge shown by the Federal Reserve in the adjustments already put forth, we are hopeful that the necessary progress will be made. Dechert will continue to monitor all developments relating to the Federal Reserve's announcements closely, and we encourage our readers to follow our regular updates on our **Term Asset-backed Securities Loan Facility ("TALF") Funds Resources website**.

This update was authored by:



[Christopher Desmond](#)

Partner
Boston
+1 617 728 7170
christopher.desmond@dechert.com



[Christopher P. Duerden](#)

Partner
Charlotte
+1 704 339 3113
christopher.duerden@dechert.com



[John M. Timperio](#)

Partner
Charlotte
+1 704 339 3180
john.timperio@dechert.com



[Mary Bear](#)

Consulting Attorney
Charlotte
1 704 339 3162
mary.bear@dechert.com



[Eric Evans](#)

Associate
Charlotte
+1 704 339 3124
eric.evans@dechert.com



[David Griffin](#)

Associate
Charlotte
+1 704 339 3116
david.griffin@dechert.com

© 2020 Dechert LLP. All rights reserved. This publication should not be considered as legal opinions on specific facts or as a substitute for legal counsel. It is provided by Dechert LLP as a general informational service and may be considered attorney advertising in some jurisdictions. Prior results do not guarantee a similar outcome. We can be reached at the following postal addresses: in the US: 1095 Avenue of the Americas, New York, NY 10036-6797 (+1 212 698 3500); in Hong Kong: 27/F Henley Building, 5 Queen's Road Central, Hong Kong (+852 3518 4700); and in the UK: 160 Queen Victoria Street, London EC4V 4QQ (+44 20 7184 7000). Dechert internationally is a combination of separate limited liability partnerships and other entities registered in different jurisdictions. Dechert has more than 900 qualified lawyers and 700 staff members in its offices in Belgium, China, France, Germany, Georgia, Hong Kong, Ireland, Kazakhstan, Luxembourg, Russia, Singapore, the United Arab Emirates, the UK and the US. Further details of these partnerships and entities can be found at dechert.com on our Legal Notices page.