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Legal Update

TALF 2020 and CLOs: Progress in the Right Direction, but Has Enough Changed?

On May 12, 2020, the Federal Reserve Bank of New York (the "New York Fed") announced the issuance of updated Terms and Conditions[1] and a Frequently Asked Questions document (the "FAQs")[2] regarding the 2020 Term Asset-Backed Securities Loan Facility ("TALF 2020").

Mayer Brown has separately published a comprehensive overview of the FAQs;[3] in this Legal Update, we focus on CLOs and highlight several aspects of the updated TALF 2020 documents with particular relevance to CLOs. In a nutshell, with respect to CLOs, the updated TALF 2020 documents provide several improvements over the terms set forth by the New York Fed on April 9, which we discussed previously.[4] Nevertheless, due to a handful of concerns that have not been addressed in the updated TALF 2020 documents, along with certain new requirements introduced for the first time in the FAQs, questions remain regarding whether TALF 2020 will be sufficiently workable for CLOs to achieve one of the program's objectives: namely, providing liquidity to American businesses that are borrowers in the leveraged loan market.

Eligible Collateral

The New York Fed's latest terms governing "eligible collateral" are a mixed bag, offering many improvements but including some terms that threaten the program's viability for CLOs.

"NEWLY ISSUED" UNDERLYING CREDIT EXPOSURES: LOOKBACK TO JANUARY 2019

Although the New York Fed has maintained the requirement that all or substantially all of the underlying credit exposures with respect to any "eligible collateral" be "newly issued," it has clarified in the FAQs that, for CLOs and certain other asset-backed securities, the New York Fed will treat the underlying credit exposures as "newly issued" if originated on or after January 1, 2019. The FAQs further clarify that, with respect to leveraged loans in CLOs, this may include loans that were refinanced on or after January 1, 2019. We noted in our April Legal Update regarding TALF and CLOs that under TALF 2008, the New York Fed had permitted underlying exposures for static ABS that were originated as early as 12-20 months (depending on asset class) prior to the commencement of TALF 2008 to constitute all or substantially all of an applicable portfolio. In a welcome clarification, the New York Fed has now adopted a lookback period of similar length for TALF 2020.

The FAQs provide that "substantially all" for this purpose means 95% or more of the principal balance of the applicable underlying assets. Accordingly, up to 5% of the portfolio of a TALF-eligible CLO can consist of loans originated prior to January 1, 2019.

REDEMPTION RESTRICTIONS

While the FAQs' lookback period for "newly issued" loans substantially eased a requirement that otherwise could have been prohibitive for the use of CLOs as collateral under TALF 2020, the introduction of substantial limitations on redemption rights in the FAQs could severely limit the utilization of TALF 2020 by CLO investors. The New York Fed states in the FAQs—in response to the question, "If the issuer of an ABS has an option to redeem such ABS prior to the maturity date (other than pursuant to a customary clean-up call), is the ABS eligible to secure a TALF loan?"—that in order to be TALF-eligible, an asset-backed security (including one issued by a CLO) cannot be subject to a redemption option prior to three years after the disbursement date of any TALF loan secured by the pledge of such asset-backed security,[5] other than pursuant to a customary clean-up call.

The construction of the question-and-answer in the FAQs leaves open the possibility that the New York Fed was addressing only redemptions that can be initiated by the issuer of an ABS, and not, for example, redemptions that can be initiated by noteholders, as in a CLO. That said, if the New York Fed's answer is meant to include those redemptions initiated by noteholders, this is problematic for CLOs, where standard non-call periods for static CLOs do not exceed one year. The purpose of the prohibition on redemption is not clear—at least in the case of optional redemptions in the CLO market—since an optional redemption is permitted to be effected in CLOs only upon repayment of the full principal amount plus accrued interest, which would not expose the New York Fed to credit risk. Furthermore, this prohibition seems inconsistent with the fact that, as the FAQs provide, the TALF loan is prepayable at any time by the borrower. Without the optionality of a redemption feature becoming available within a standard shorter timeframe, TALF-eligible CLOs are expected to be much less attractive to equity investors, which could make it challenging to issue such a CLO.

LIBOR FALLBACK LANGUAGE REQUIREMENT

The FAQs state that the New York Fed generally will expect any ABS benchmarked to LIBOR to include adequate fallback language, such as that recommended by the Alternative Reference Rates Committee (the "ARRC") or substantially similar fallback language. CLOs are typically benchmarked to LIBOR. Many recently issued CLOs include fallback language that, while not identical to the fallback language that ARRC has recommended for securitizations, market participants may reasonably consider substantially similar to the fallback language that the ARRC has recommended for securitizations.

The FAQs additionally introduce a requirement with respect to LIBOR fallback language in the loans underlying an eligible CLO. In order for a CLO to be TALF-eligible, underlying loans with interest rates tied to LIBOR "are generally expected to have adequate fallback language." Loans generally must have either LIBOR fallback language recommended by the ARRC, or "substantially similar fallback language (as prevailing in the relevant market when the loan was originated)."

The ARRC's recommendations for LIBOR fallback language for syndicated loans, which were finalized in April 2019 following a consultation commenced in September 2018, include two sets of recommended fallbacks, one based on an "amendment approach" and the other based on a "hardwired approach." A determination of what constitutes LIBOR fallback language that is "substantially similar" to the ARRC-recommended fallback language is not clear-cut. As it is, the

ARRC's recommendations were not finalized until April 2019, i.e., after the January 2019 lookback date for "newly issued loans" that must constitute substantially all of the portfolio of a TALF-eligible CLO. But the reference to fallback language prevailing in the relevant market when the loan was originated provides an apparent basis for a conclusion that fallback provisions in leveraged loans originated as early as January 2019 (and before) are substantially similar to the ARRC-recommended "amendment approach."

STATIC CLO REQUIREMENT

The requirement that in order to be TALF-eligible a CLO must be static has remained unchanged in the updated TALF 2020 documents. The FAQs state that a reinvestment period for a TALF-eligible CLO can only begin three years after the disbursement date of any TALF loan secured by the pledge of such CLO, as long as the senior-most tranche of the CLO is not owned by the New York Fed or by the TALF SPV.[6] It is unclear whether a delayed reinvestment period would be attractive to CLO collateral managers and investors; as a result, the more likely outcome may be that any TALF-eligible CLOs will be structured to be static for their entire term.

The FAQs state that managers of TALF-eligible CLOs will be permitted to sell defaulted loans, subject to the proceeds of such sales being used to amortize CLO debt. Though there was an industry request to permit sales of credit risk obligations and equity securities or other securities received in a workout, the FAQs do not permit such sales. Furthermore, the description of what constitutes a defaulted loan in the FAQs (namely, a loan that has defaulted in the payment of interest and principal) is narrower than the typical definition of defaulted obligations in CLOs.

ADDITIONAL PORTFOLIO CRITERIA; OVERCOLLATERALIZATION TEST REQUIREMENT

The New York Fed has introduced other portfolio requirements for TALF-eligible CLOs. In addition to the requirement that each loan be senior secured and current on principal and interest, the FAQs include the following portfolio requirements:

- a maximum concentration of second-lien loans of 10%;
- a maximum concentration for debtor-in-possession (DIP) loans of 7.5%;
- a maximum concentration for covenant-lite loans[7] of 65% in the case of a broadly syndicated CLO[8] and 10% for a middle market CLO;[9] and
- a maximum single-obligor concentration of 4%.

Additionally, no more than 4% of the portfolio of a TALF-eligible CLO may consist of loans with an obligor that is either the TALF borrower or an affiliate of the TALF borrower. For purposes of this requirement, the definition of "affiliate" will be as set forth in the Master Loan and Security Agreement that will govern TALF 2020 loans, which has not yet been published by the New York Fed. This restriction may be relevant to TALF borrowers affiliated with private equity sponsors that own portfolio companies that are borrowers of leveraged loans.

In order to be TALF-eligible, a CLO is also required to include at least one overcollateralization test redirecting cash flows to the TALF-eligible senior tranche in the event of deterioration in the underlying loan portfolio of the CLO.

ELIGIBLE ISSUERS

A welcome development in the updated TALF 2020 documents is the removal of the requirement that an issuer of eligible ABS for TALF 2020 be a U.S. company. For CLOs, which often use an issuer

domiciled in the Cayman Islands, the requirement in the April 9 Terms and Conditions that the issuer be a U.S. company has been replaced by a requirement that the manager of the CLO has its principal place of business in the U.S.

UNDERLYING CREDIT EXPOSURES – U.S. NEXUS

The April 9 Terms and Conditions required that all or substantially all of the credit exposures underlying the given TALF-eligible asset-backed security must have been originated by a U.S. company. Following industry comment, this was changed with respect to CLOs to require instead that each underlying loan must have a lead or co-lead arranger that is a U.S.-organized entity (which may include a U.S. branch or agency of a foreign bank). Additionally, all or substantially all of the loans in a TALF-eligible CLO must be made to U.S.-domiciled obligors. CLOs should generally not have difficulty complying with these requirements.

DUAL RATING REQUIREMENT

The New York Fed maintained the requirement that an eligible CLO have the highest credit ratings from at least two eligible nationally recognized statistical rating organizations. The industry had noted to the New York Fed that static CLOs typically obtain only one rating.

Eligible Borrowers

U.S. BRANCH OF NON-U.S. BANK/NON-U.S. PARENT

In our April Legal Update regarding TALF and CLOs, we noted that it would be helpful if the New York Fed confirmed the status of the following entities as eligible borrowers:

- A U.S. branch or agency of a non-U.S. bank.
- A U.S. entity with a non-U.S. parent company.

With respect to the former, the FAQs indicate that a U.S. branch or agency of a non-U.S. bank may be an eligible borrower, expressly stating that a U.S. subsidiary or U.S. branch or agency of a foreign bank would be considered to meet the requirement of being "created or organized in the United States or under the laws of the United States." The FAQs note that such branch or agency must also satisfy all of the other relevant criteria to qualify as an eligible borrower under TALF, but the statement that these entities meet the threshold inquiry in the jurisdictional test is significant.

As for the latter, the FAQs are less clear as to whether a U.S. entity with a non-U.S. parent company may be an eligible borrower, because they do not expressly state that such an entity meets the eligible borrower criteria requiring that it have significant operations in and a majority of its employees based in the United States (which we will refer to as the "U.S. business" test). Nonetheless, the New York Fed states that it "would not consider any parent company or sister affiliate" when evaluating whether an entity meets the "U.S. business" test, which suggests that a U.S. entity can be considered an eligible borrower even if its parent is a non-U.S. company.

FUNDS

In another improvement, the updated TALF 2020 documents clarify that investment funds may be eligible borrowers. There were concerns surrounding treatment of investment funds (which generally do not have employees) in light of the "U.S. business" test. The FAQs resolved this concern by stating that for a borrower organized as an investment fund, the investment manager of such fund must have significant operations and a majority of its employees based in the United States. In other

words, a fund that is a U.S. entity can meet the "U.S. business" test through its investment manager. This tracks the approach in the TALF program that operated during the Great Financial Crisis ("TALF 2008").

MATERIAL INVESTORS

While there are improvements regarding borrower eligibility, certain other provisions regarding borrowers introduced by the New York Fed in its FAQs may pose challenges. The New York Fed states in the FAQs that its monthly public disclosures on TALF 2020 will include not only the identity of each borrower but also the identity of each "Material Investor" of a borrower. "Material Investor" is defined to be any person who owns, directly or indirectly, 10% or more of any outstanding class of securities of such entity. Further, the FAQs state that a TALF borrower will be expected to have a mechanism for continuously monitoring its direct and indirect investors as long as its TALF loan is outstanding. If an investor's direct or indirect ownership interest in the borrower reaches the Material Investor threshold, the borrower will be required to escalate the holding of such Material Investor to its TALF Agent for due diligence review. It is possible that a fund manager or others associated with a prospective TALF borrower might find the public disclosure of its 10% direct and indirect investors too invasive or the diligence and reporting requirements too onerous or impractical.[10]

CERTIFICATION REGARDING INABILITY TO SECURE OTHER ADEQUATE CREDIT ACCOMMODATIONS

The FAQs state that a borrower will be required to certify "that it is unable to secure adequate credit accommodations from other banking institutions…." This is in accordance with Section 13(3) of the Federal Reserve Act, the statute that authorizes the Federal Reserve to establish liquidity facilities in "unusual and exigent circumstances," and a related regulation. The New York Fed has set forth a similar certification requirement for other COVID-19 crisis facilities, namely the Commercial Paper Funding Facility, the Primary Market Corporate Credit Facility, the Secondary Market Corporate Credit Facility and the Municipal Liquidity Facility.[11] The relevant regulation specifically states that the Section 13(3) requirement of evidence regarding inability to secure adequate credit accommodations may be satisfied by a certification from the program borrower.[12]

In the FAQs, the New York Fed states by way of guidance that the borrower's certification "may be based on unusual economic conditions in the market or markets intended to be addressed by the TALF. Lack 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." This guidance notwithstanding, it is not clear what borrowers need to establish in order to support a certification as to inability "to secure adequate credit accommodations." In the absence of further guidance from the New York Fed this certification requirement could be a disincentive for borrowers to access TALF 2020 funding. The FAQs state that borrower certifications with more detailed instructions will be forthcoming.

Other Terms

PRICING

Pricing terms for TALF loans for CLO notes have not changed. The pricing is the 30-day average secured overnight financing rate (SOFR) plus 150 basis points. The use of SOFR as the index will create a basis mismatch with any CLO that pays interest based on LIBOR, which is currently standard for CLOs and can be expected to remain so given that most loans backing CLOs pay interest based

on LIBOR.[13] The basis risk is made more acute by the fact that a CLO must be static to be TALF-eligible; loan amortization makes effective hedging more challenging.

In addition, notwithstanding industry comment, the New York Fed has maintained a haircut rate of 20-22% for CLOs pledged as collateral. The industry had noted to the New York Fed that this haircut was higher than for other ABS assets and had requested a lower haircut for CLOs, taking into account the strong performance record of AAA CLOs relative to other asset classes with lower haircuts. It remains to be seen whether the TALF 2020 economic terms for CLOs will be attractive enough for CLO investors.

PROGRAM TERMINATION DATE

The New York Fed has maintained a September 30, 2020 termination date for the making of TALF loans, unless TALF 2020 is extended by the Board of Governors of the Federal Reserve System and the Department of the Treasury. The industry had requested that the termination date be a later date such as the end of the year, given the amount of time it takes to launch a CLO.

ISSUER CERTIFICATIONS AND AUDITOR ASSURANCES

The FAQs state that further information will be forthcoming regarding documentation requirements related to issuer certifications and auditor assurances for newly issued ABS. The willingness of auditors to provide any required assurances with respect to CLOs, the identity of the party required to provide issuer certifications with respect to CLOs, and the nature and extent of such certifications may each impact the likelihood that CLOs will be structured to be eligible collateral under TALF 2020.

Conclusion

The updated TALF 2020 documents include several welcome improvements for CLOs, for example, the lookback for underlying loans to January 2019 and the removal of the requirement that the issuer be a U.S. entity. That said, the updated program documents also maintained and even introduced a few drawbacks for CLOs, for example, the retention of the requirement that a CLO be static for at least three years; the prohibition of a call right exercisable before three years; the requirement that the underlying loans include specified LIBOR fallback language; the retention of the pricing of 30-day average SOFR plus 150 basis points, with the associated basis risk given the expected LIBOR basis of the reference rate for the AAA notes; and the 20-22% haircut for CLOs pledged as collateral.

It remains to be seen whether investors will make use of TALF 2020 to finance CLO investments and whether the terms of the program will evolve, as did the terms of TALF 2008 over the course of that program. It cannot be ruled out that market input will prompt the New York Fed to further revise the terms of TALF 2020 in order to best achieve the program objective of providing liquidity via CLOs to American businesses that are leveraged loan borrowers.

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Endnotes

[1] https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200512a1.pdf

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

[3] *See* "TALF 2020 Update: Federal Reserve Bank of New York Releases FAQs and Revised Term Sheet," May 15, 2020; https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2020/05/federal-reserve-bank-of-new-york-releases-talf-faq.pdf

[4] *See* "Legal Update: TALF 2020 and CLOs," April 10, 2020; https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2020/04/talf-2020-and-clos.pdf

[5] It should be noted that while a TALF loan could be obtained through the duration of the TALF availability period, which is currently scheduled to run through September 30, 2020, in order for a CLO to be eligible collateral for one or more TALF loans funded on the closing date of the CLO, the end of the non-call period should only need to be structured by reference to the period of time commencing on the CLO closing date, with the understanding that the CLO would not be eligible collateral for TALF loans to be funded after the CLO closing date. In accordance with the FAQs, the CLO would also need to provide that optional redemption is prohibited at any time when the New York Fed or the TALF SPV owns the CLO collateral, but that would presumably only extend beyond the three-year period in an enforcement situation where the TALF SPV had foreclosed on the CLO collateral, a circumstance that would appear unlikely.

[6] It should again be noted that while a TALF loan could be obtained through the duration of the TALF availability period, which is currently scheduled to run through September 30, 2020, in order for a CLO to be eligible collateral for one or more TALF loans funded on the closing date of the CLO, the three-year period during which reinvestment is prohibited (similar to the length of the non-call period discussed above) would presumably only need to be structured by reference to the period of time commencing on the CLO closing date, with the understanding that the CLO would not be eligible collateral for TALF loans to be funded after the CLO closing date.

[7] The FAQs set out a detailed definition of a covenant-lite loan for purposes of TALF 2020, which includes several provisions that are common in the CLO market.

[8] A broadly syndicated CLO is defined in the FAQs as 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.

[9] A middle market CLO is defined in the FAQs as 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.

[10] The FAQs also state that each eligible borrower will be required to certify as to the conflicts of interest requirements of Section 4019 of the CARES Act. Other COVID-19 crisis facilities have similar conflicts of interest requirements in accordance with Section 4019. The Fed has published instructions relating to such requirements under the Secondary Market Corporate Credit Facility (https://www.newyorkfed.org/markets/secondary-market-corporate-credit-facility/secondary-market-corporate-credit-facility-seller-certification), which require that diligence be undertaken with respect to beneficial owners of any 5% or greater equity interest of the applicant. As with the Material Investor requirements, it is possible that prospective TALF borrowers (particularly those with multiple levels of ownership) may find the diligence necessary to establish the basis for such a certification to be too onerous or impractical.

[11] *See*, *e.g*., https://www.newyorkfed.org/markets/primary-and-secondary-market-faq/corporate-credit-facility-faq

[12] Regulation A (Extensions of Credit by Federal Reserve Banks), 12 CFR §201.4(d)(8). When the Federal Reserve introduced the concept of a certification regarding inadequate alternative credit accommodations in December 2015, it stated that, in response to comment, it added the possibility of a program participation certification as evidence satisfying the Section 13(3) requirement. 80 FR 78959, "Extensions of Credit by Federal Reserve Banks," at 78966.

[13] The FAQs state that interest rates will be set one day prior to the subscription date. For floating TALF interest rates such as the SOFR-based rate applicable to TALF loans collateralized by CLOs, the rate will presumably be reset at periodic intervals corresponding to the TALF payment periods (since if it were only set once on the subscription date, it would effectively be a fixed rate), but the FAQs are currently silent on this point.

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