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Client Alert

TALF Expanded to Include AAA Tranches of Static CLOs

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On April 9, 2020, the Board of Governors of the Federal Reserve System (the "**Federal Reserve**") issued a press release[1] indicating that the Term Asset-Backed Securities Loan Facility ("**TALF**") would be expanded to include AAA tranches of certain newly-issued collateralized loan obligation ("**CLO**") securities as eligible collateral thereunder. The Federal Reserve limited eligible CLO collateral to static CLOs backed by leveraged loans, meaning that securities issued by actively managed CLOs and commercial real estate CLOs will not constitute eligible collateral for TALF. While the requirement that underlying credit exposures must be "newly issued" could limit the value of this program to CLO managers in the current market environment, the inclusion of AAA tranches of static CLO securities in the scope of eligible collateral for TALF is a positive development for the CLO market.

BACKGROUND

The original TALF was a credit facility created in response to the 2008 financial crisis, to support the issuance of asset-backed securities ("**ABS**") and the flow of credit to the economy. TALF has been re-established in connection with the federal government's attempts to support the economy during the COVID-19 pandemic. The purpose of TALF is to "support further credit flow to households and businesses"[2] by supporting the issuance of asset-backed securities that facilitate lending activities. The Federal Reserve established the new TALF on March 23, 2020 and released a term sheet setting forth the scope of eligible borrowers, eligible collateral, and other aspects of TALF. Although CLO securities were not eligible collateral under the first term sheet, the revised term sheet issued April 9, 2020 includes as eligible collateral ABS where the underlying credit exposures are leveraged loans, which brings CLO securities within the scope of TALF. More detailed terms and conditions of the program will be released by the Federal Reserve when finalized.

OPERATION OF TALF FOR CLOs

Under the TALF program, the Federal Reserve Bank of New York ("**Reserve Bank**") will commit to lend to a special purpose vehicle (the "**TALF SPV**") on a recourse basis. The Treasury Department will also

[1] The Federal Reserve's press release is available online at: https://www.federalreserve.gov/newsevents/pressreleases/monetary20200409a.htm.

[2] Id.

make a $10 billion equity investment to the TALF SPV. The TALF SPV in turn will lend to eligible borrowers that hold certain AAA-rated ABS backed by newly originated loans. Loans made under the TALF program will have a term of three years,[3] will be non-recourse to the borrower and will be secured by the eligible ABS. TALF loans backed by CLO collateral will have an interest rate 150 basis points over the 30-day average secured overnight financing rate ("**SOFR**"). The eligible collateral is subject to haircuts as set forth in the TALF term sheet, with the haircut for ABS backed by underlying leveraged loan collateral set at 20-22%. TALF loans may be prepaid in whole or in part at the option of the borrower. Substitution of collateral is generally not allowed.

The Federal Reserve has indicated that the TALF SPV will initially make available up to $100 billion of loans. This injection of liquidity into the debt capital markets should facilitate the issuance of ABS and the underlying extensions of credit. Extensions of credit under TALF are scheduled to terminate on September 30, 2020 unless extended by the Federal Reserve and the Department of the Treasury.

ELIGIBLE BORROWERS AND ELIGIBLE COLLATERAL FOR CLO INVESTMENTS

Eligible Borrowers

To be eligible to borrow funds under the TALF program, a prospective borrower must be a US company that owns eligible collateral and maintains an account relationship with a primary dealer[4]. In the April 9, 2020 term sheet, the Federal Reserve stated that for purposes of the TALF term sheet, a US company is "a business that is created or organized in the United States or under the laws of the United States and that has significant operations in and a majority of its employees based in the United States."[5]

Eligible Collateral

In order for ABS, including CLO notes, to constitute eligible collateral under the TALF program, they must be US dollar denominated cash (not synthetic) ABS with a credit rating "in the highest long-term or, in the case of non-mortgage backed ABS, the highest short-term investment-grade rating category from at least two eligible nationally recognized statistical rating organizations ("**NRSROs**")"[6] and not have a credit rating below the highest investment-grade rating category from an eligible NRSRO. This requirement effectively limits eligible collateral to the US dollar-denominated AAA-rated tranches of cash ABS. Additionally, all or substantially all of the assets underlying the ABS must have been originated by a US company and the issuer of eligible collateral must be a US company. In order for CLO notes to constitute eligible collateral, they must have been issued on or after March 23, 2020, and all or substantially all of the underlying credit exposures must be "newly issued."[7]

Eligible collateral does not include ABS with interest payments that step up or step down to predetermined levels on specific dates. Additionally, the underlying credit exposures of eligible collateral

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[3] We note that under the original TALF, investors could initially only receive three-year loans, but the Federal Reserve eventually extended potential loan maturities to five years to finance purchases of commercial mortgage-backed securities, ABS backed by student loans, and ABS backed by loans guaranteed by the Small Business Administration. See https://www.federalreserve.gov/monetarypolicy/otherlending_TALF200906.htm.

[4] Primary dealers are financial institutions that are trading counterparties of the Reserve Bank. See https://www.newyorkfed.org/markets/primarydealers.

[5] TALF term sheet, available online at https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200409a1.pdf.

[6] Id.

[7] While the April 9, 2020 term sheet provides that all or substantially all of the underlying credit exposures must be "newly issued", a recent report that the Federal Reserve filed with Congress provides that "[e]ligible ABS would be AAA-rated ABS for which all or substantially all of the underlying credit exposures are newly or recently originated exposures to US borrowers." See Report to Congress Pursuant to Section 13(3) of the Federal Reserve Act: Term Asset-Backed Securities Loan Facility (March 30, 2020), available online at https://www.federalreserve.gov/publications/files/term-asset-backed-securities-loan-facility-3-29-20.pdf.

must not include exposures that are themselves cash ABS or synthetic ABS. The Federal Reserve has indicated that it will in the future consider adding asset classes or expanding the scope of existing asset classes for the TALF facility.

ISSUES FOR CLOs AND POSSIBLE IMPROVEMENTS TO TALF

The addition of ABS backed by leveraged loans as “eligible collateral” under TALF is a welcome development for the CLO market. Absent additional modifications, however, a few practical issues will limit the value of TALF to the CLO market and, more importantly, limit the TALF program from maximizing its stated objectives. First, the requirement that the underlying credit exposures must be “newly issued,” without further definition, could be problematic given limited origination of leveraged loans in the current COVID-19 crisis. Eliminating that requirement or interpreting “newly issued” to include credit exposures issued in the recent past – as was done with the original TALF[8], would allow CLOs that are currently in their warehouse financing stage to close and produce collateral eligible for TALF financing and would thereby increase liquidity in the leveraged loan and CLO markets generally. It also would be useful if the interest rate for TALF financing were not SOFR-based given that CLO assets are priced using LIBOR as a benchmark rate, thereby creating a potential mismatch, particularly in a rising interest rate environment, which is a future possibility. In addition, the limitation of eligible CLO collateral to only static CLOs is also not ideal considering that actively managed CLOs permit the CLO manager to manage credit exposure by trading out of loans that present undue credit risk or may default; however, it is understandable that in financing the purchase of certain CLO notes, the government is focused on lending against a specific and identifiable pool of assets to which initial haircuts will be applied uniformly. Finally, another possible issue for CLOs is the requirement that the issuer of eligible ABS collateral be a US company; however, this requirement may be satisfied because most CLOs have a US co-issuer for investment grade tranches, including the AAA tranche, even though the CLO issuer is an offshore entity. Alternatively, newly-issued CLOs can be structured with domestic issuers, although that may pose certain procedural hurdles to non-US investors in those CLOs.

[8] See Term Asset-Backed Securities Loan Facility: Terms and Conditions (April 21, 2009), available online at https://www.newyorkfed.org/markets/talf_Terms_090303.html. Eligible underlying credit exposures under the terms and conditions for the original TALF included credit exposures originated prior to the announcement of the original TALF but after a specified date, which date varied by asset class. The April 9, 2020 term sheet provides that “[t]he detailed terms and conditions will further define the eligible underlying credit exposures for purposes of the TALF” and that “[t]he definitions are expected to be broadly consistent with the defined terms used for purposes of the TALF established in 2008.”

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