

## Client Alert

### TALF Clarifications Materially Beneficial for CLOs

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#### Contact

**Deborah Festa, Partner**  
+1 424.386.4400  
+1 212.530.5540  
[dfesta@milbank.com](mailto:dfesta@milbank.com)

**Catherine Leef Martin, Partner**  
+1 212.530.5189  
[cmartin@milbank.com](mailto:cmartin@milbank.com)

**Andrew Keller, Associate**  
+1 424.386.4408  
[akeller@milbank.com](mailto:akeller@milbank.com)

**Devan Zorn, Associate**  
+1 212.530.5699  
[dzorn@milbank.com](mailto:dzorn@milbank.com)

On May 12, 2020, the Board of Governors of the Federal Reserve System (the “**Federal Reserve**”) issued a press release<sup>1</sup> regarding the Term Asset-Backed Securities Loan Facility (“**TALF**”) that included links to a revised term sheet<sup>2</sup> (the “**May Term Sheet**”) and answers to new FAQs (the “**FAQs**”).<sup>3</sup> The FAQs contain significant clarifications to certain program terms that on the whole should be a catalyst for new collateralized loan obligation (“**CLO**”) issuance in the near future.

As described in our client alert of April 9, 2020,<sup>4</sup> the previous TALF term sheet, issued on that same date (the “**April Term Sheet**”), announced that AAA tranches of static CLOs would constitute eligible collateral under TALF and required the underlying credit exposures to be “newly issued” without defining the meaning of that term. The May Term Sheet helpfully clarifies that leveraged loans originated on or after January 1, 2019 qualify as underlying credit exposures for eligible TALF collateral.

#### SOME MEANINGFUL CLARIFICATIONS

While the May Term Sheet remains largely unchanged where CLO collateral is concerned, certain answers in the FAQs provide crucially important details for interpreting the terms previously announced in the April Term Sheet.

##### *Scope of “newly issued”*

The FAQs clarify that the requirement that all or substantially all of the leveraged loans underlying CLOs be “newly issued” means that they must be originated on or after January 1, 2019 and may include loans that have been refinanced on or after January 1, 2019. The FAQs also state that “all or substantially all”

<sup>1</sup> The Federal Reserve’s press release is available online at: <https://www.federalreserve.gov/newsevents/pressreleases/monetary20200512a.htm>.

<sup>2</sup> The May Term Sheet is available online at: <https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200512a1.pdf>.

<sup>3</sup> The FAQs are available online at: <https://www.newyorkfed.org/markets/term-asset-backed-securities-loan-facility/term-asset-backed-securities-loan-facility-faq>.

<sup>4</sup> Our April 9, 2020 client alert is available online at: <https://www.milbank.com/en/news/talf-expanded-to-include-aaa-tranches-of-static-clos.html>.

in this context means 95% or more of the principal balance of the underlying assets in the ABS, allowing for up to 5% of the underlying loans to be originated prior to January 2019. These clarifications should help facilitate the securitization of most assets that were in warehouse facilities at the time of the COVID-19 shutdown. TALF otherwise would have very limited value for the CLO market given the dearth of new leveraged loan issuance since that shutdown.

#### *Static CLOs may sell defaulted assets*

The April Term Sheet limited eligible CLO collateral to static CLOs backed by leveraged loans, meaning that securities issued by actively managed CLOs would not constitute eligible collateral for TALF. While the May Term Sheet maintains the static CLO requirement<sup>5</sup>, the FAQs clarify that CLOs may sell defaulted loans (albeit not merely credit risk loans, as is usually the case), provided that the proceeds of such sales may not be reinvested and must be used to amortize the CLO.

#### *U.S. CLO managers only*

The collateral manager of an issuer of CLO eligible collateral must have its principal place of business in the US.

#### *No optional redemption*

The FAQs clarify that a CLO issuer may not have an optional redemption feature, other than a customary “clean-up call” redemption right; however, the FAQs indicate that CLOs will be permitted to sell underlying loans to sponsors at par (plus accrued interest), where the cash proceeds are applied to amortize the CLO.

#### *No requirement for CLO issuer of eligible collateral to be US company*

The April Term Sheet required that the issuer of eligible collateral be a US company, which generated concern because CLO issuers are typically offshore companies. The May Term Sheet omits that requirement. Therefore, the use of a typical CLO structure with an offshore issuer should be fine for purposes of TALF.

### **NEW REQUIREMENTS FOR ELIGIBLE CLO COLLATERAL**

The FAQs also provide additional clarity concerning other structuring aspects for eligible CLO collateral, including that “the underlying leveraged loans must be current on principal and interest, senior secured, and subject to the following additional portfolio limitations as of the subscription date:

- Maximum second lien loan concentration of 10 percent.
- Maximum debtor in possession (DIP) loan concentration of 7.5 percent.
- Maximum covenant lite loan concentration of 65 percent for broadly syndicated CLOs and 10 percent for middle market CLOs<sup>6</sup>.
- Maximum single underlying obligor concentration of 4 percent.”<sup>7</sup>

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<sup>5</sup> Note that the FAQs do clarify that there can be a reinvestment period, but only if it begins at least three years after the disbursement of any TALF loan; however, reinvestment will not be permitted at any time when the senior-most tranche of a CLO is owned by the New York Fed or the TALF SPV.

<sup>6</sup> Helpfully, the definition of covenant lite loan includes a proviso that clarifies that a loan that contains a cross-default or cross-acceleration provision to, or is *pari passu* with, another loan of the same obligor that requires the obligor to comply with financial covenants will be deemed not to be a covenant lite loan.

<sup>7</sup> See FAQs (cited in note 3).

Not surprisingly, eligible CLOs must include at least one overcollateralization test redirecting cash flow from the equity and subordinated tranches of the securitization to the TALF-eligible senior tranche in the event of deterioration in the underlying loan portfolio.

The May Term Sheet also requires that the lead or co-lead arranger of the credit exposures underlying an eligible CLO be a U.S.-organized entity (including a U.S. branch or agency of a foreign bank). Furthermore, the FAQs provide that underlying leveraged loans with interest rates tied to LIBOR should have adequate fallback language, which may be the language recommended by the Alternative Reference Rates Committee or substantially similar fallback language (as prevailing in the relevant market when the loan was originated).

Unlike typical CLOs, a TALF-eligible CLO will require the CLO issuer to disclose in its offering circular the average life of the CLO notes that will serve as collateral for a TALF loan.

## **CONCLUSION**

The Federal Reserve's answers in the FAQs significantly increase the potential for TALF to provide meaningful support for the CLO market and the market for leveraged loans that underly CLOs. The clarification concerning the "newly issued" underlying loan eligibility requirement is arguably the most helpful. In providing an anticipated boost for new CLO issuance using collateral that has remained in warehouse facilities since the onset of the COVID-19 shutdown, these helpful steps on the part of the Federal Reserve should promote increased liquidity and balance sheet capacity for financial institutions that lend to corporate borrowers in need of funding in this critical hour.

New York

55 Hudson Yards, New York, NY 10001

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John Britton	<a href="mailto:jbritton@milbank.com">jbritton@milbank.com</a>	+1 212.530.5284
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Deborah Festa	<a href="mailto:dfesta@milbank.com">dfesta@milbank.com</a>	+1 212.530.5540
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Jay D. Grushkin	<a href="mailto:jgrushkin@milbank.com">jgrushkin@milbank.com</a>	+1 212.530.5346
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Catherine Leef Martin	<a href="mailto:cmartin@milbank.com">cmartin@milbank.com</a>	+1 212.530.5537
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Eric K. Moser	<a href="mailto:emoser@milbank.com">emoser@milbank.com</a>	+1 212.530.5388
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Albert A. Pisa	<a href="mailto:apisa@milbank.com">apisa@milbank.com</a>	+1 212.530.5319
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Sean M. Solis	<a href="mailto:ssolis@milbank.com">ssolis@milbank.com</a>	+1 212.530.5898
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Blair M. Tyson	<a href="mailto:btyson@milbank.com">btyson@milbank.com</a>	+1 212.530.5233
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John Williams	<a href="mailto:jwilliams@milbank.com">jwilliams@milbank.com</a>	+1 212.530.5537
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Los Angeles

2029 Century Park East, 33<sup>rd</sup> Floor, Los Angeles, CA 90067

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Deborah Festa	<a href="mailto:dfesta@milbank.com">dfesta@milbank.com</a>	+1 424.386.4400
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London

10 Gresham Street, London, UK EC2V 7JD

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John Goldfinch	<a href="mailto:jgoldfinch@milbank.com">jgoldfinch@milbank.com</a>	+44 20.7615.3109
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James Warbey	<a href="mailto:jwarbey@milbank.com">jwarbey@milbank.com</a>	+44 20.7615.3100
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