WINSTON & STRAWN LLP

CLIENT ALERT

Federal Reserve – TALF Applicability to CLOs

MAY 13, 2020

On Tuesday, May 12, 2020, the Federal Reserve issued a press release announcing that it was taking action to provide up to $100 billion in loans to support consumers' and businesses' access to the credit markets through the issuance of asset-back securities. The Federal Reserve also released a revised term sheet as well as an initial list of FAQs for the previously announced proposed facility, the Term Asset-Backed Loan Facility (TALF or the Facility). A copy of the press release, including links to the revised term sheet and FAQs, can be found here. A summary of certain key terms of the Facility as they relate to collateralized loan obligation transactions (CLOs) is set forth below.

The Federal Reserve and the Department of the Treasury (Treasury) may make adjustments to the terms and conditions set forth above, and any changes will be announced by the Federal Reserve.

Overview

Under the Facility, the Federal Reserve Bank of New York (Reserve Bank) will lend to a special purpose vehicle (SPV) on a recourse basis, and the SPV will, in turn, lend up to $100 billion to eligible borrowers and will be fully secured by eligible collateral. The Treasury will make a $10 billion equity investment in the SPV using funds appropriated under the Coronavirus Aid, Relief, and Economic Security Act.

Eligible Borrowers

Eligible Borrowers (other than investment funds) include investors (including U.S. subsidiaries or U.S. branches of a foreign bank) that:

a. are created or organized in the United States or under the laws of the United States,

b. have significant operations in and a majority of their employees based in the United States, and

c. maintain an account relationship with a primary dealer.

An investment fund will constitute an Eligible Borrower if the investment manager has significant operations in, and a majority of its employees are based in, the United States.

Eligible Collateral

Eligible Collateral, which was expanded earlier this year to include securities backed by leveraged loans, must:

a. have a credit rating in the highest long-term or, if no long-term rating is available, the highest short-term investment-grade rating category from at least two of Moody's, S&P or Fitch,

b. be issued by a static CLO [1] that is managed by investment manager with its principal place of business in the United States,

c. be backed by all or substantially all newly issued underlying loans that (1) have a lead or co-lead arranger that is organized in the United States (including a U.S. branch of a foreign bank) and (2) have U.S-domiciled obligors.

"Substantially all newly issued underlying loans" requires at least 95% of the dollar amount of the underlying loans having been originated or refinanced on or after January 1, 2019.

Significantly, the Federal Reserve eliminated a previous requirement that the issuer of the Eligible Collateral be a U.S. company, which should permit the typical CLO structure with a Cayman Islands issuer to be treated as Eligible Collateral.

With respect to CLOs, the Facility also includes the following requirements:

a. the underlying loans must be current on principal and interest and senior secured,

b. the portfolio must include the following concentration limitations:

- maximum second lien loan concentration of 10%,
- maximum DIP loan concentration of 7.5%
- maximum covenant lite loan [2] concentration of 65% for broadly syndicated CLOs [3] and 10% for middle market CLOs,[4] and
- maximum single underlying obligor concentration of 4%,

c. the CLO must include at least one overcollateralization test redirecting cash flow to the TALF-eligible senior tranche in the event of deterioration in the underlying loan portfolio, and

d. the CLO may not allow for a redemption option prior to three years after the TALF loan is disbursed or at any time when the ABS is owned by the Reserve Bank or the TALF SPV, other than a customary clean-up call.[5]

Loan Terms

The maximum loan amount is equal to the market value of the pledged collateral, minus a haircut. For CLOs, the Federal Reserve will apply a haircut of 20% for deals with average lives of up to five years, and the haircut will increase by one percentage point for each additional year (or portion thereof) of average life. The average life for a CLO cannot be greater than 10 years.

The interest rate for TALF loans secured by CLOs is 150 basis points over the 30-day average SOFR, payable quarterly.

The borrower must pay the TALF SPV an administrative fee equal to 10 basis points on the loan amount.

No new TALF loans will be made after September 30, 2020, unless the Federal Reserve and the Treasury extend the Facility.

Practical Suggestion

While a launch date for the Facility has not yet been announced, potential borrowers and investment managers are encouraged to contact their relationship managers at their arranger banks now to get in the queue and be ahead of the curve.

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[1] The Federal Reserve defines a "static CLO" for purposes of TALF as a CLO that does not include a period of reinvestment of collateral proceeds, including principal or interest proceeds and proceeds on the sale of defaulted underlying leveraged loans, unless such period of reinvestment begins at least three years after the TALF loan is disbursed or at any time when the senior-most tranche is owned by the Reserve Bank or the TALF SPV. However, the Facility permits sales of (1) loans for cash at their par amount, plus accrued interest, to a sponsor, or (2) loans that have defaulted in payment of principal and interest so long as, in each case, proceeds are used to amortize the CLO.

[2] The Federal Reserve has adopted a common CLO definition for a "covenant-lite loan" – "a senior secured loan that: (a) does not contain any financial covenants or (b) does not contain any maintenance covenants (*i.e.,* financial covenants applicable during each reporting period whether or not a borrower has taken any specified action); provided that a loan described in clause (a) or (b) above that contains either a cross-default or cross-acceleration provision to, or is pari passu with, another loan of the underlying obligor that requires the underlying obligor to comply with (i) a maintenance covenant or (ii) one or more financial covenants that apply only upon the occurrence of certain actions of the underlying obligor will be deemed not to be a covenant-lite loan. For the avoidance of doubt, a loan that is capable of being described in clause (a) or (b) above only (x) until the expiration of a certain period of time after the initial issuance thereof or (y) for so long as there is no funded balance in respect thereof, in each case as set forth in the related underlying instruments, will be deemed not to be a covenant-lite loan."

[3] A broadly syndicated CLO is defined 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 percent of the portfolio to be comprised of leveraged loans to obligors with total potential indebtedness of $150,000,000 to $250,000,000."

[4] A middle-market CLO is defined 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."

[5] For purposes of TALF, a "customary clean-up call" will apply "when the remaining balance of the assets or the liabilities of the issuer is not more than 10 percent (or a higher percentage customarily used by the sponsor in its securitizations that were offered before the TALF program was established) of the original balance of such assets or liabilities."

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