

ALERTS

TALF 2.0: CLOs as Eligible Collateral

May 13, 2020

On March 23, 2020, the Board of Governors of the Federal Reserve System (“Federal Reserve”) authorized the Federal Reserve Bank of New York (“New York Fed”) to establish the Term Asset-Backed Securities Loan Facility (“TALF 2.0”).^[1] TALF 2.0 is intended to facilitate the issuance of eligible asset-backed securities (“ABS”) to stabilize ABS markets to counter disruptions associated with COVID-19. Under TALF 2.0, the New York Fed will commit to lend funds to a special purpose vehicle (“TALF SPV”) which will make loans (“TALF Loans”) available to eligible borrowers on a non-recourse basis, to be fully secured by eligible ABS collateral. The TALF SPV will initially make up to \$100 billion of loans available. Each TALF Loan will have a maturity of three years, will be pre-payable in whole or in part at the option of the borrower and will be issued pursuant to a master loan and security agreement. TALF 2.0 will be available until Sept. 30, 2020, unless the program is extended.

The New York Fed issued FAQs and updated terms and conditions for TALF 2.0 on May 12, 2020, with guidance on what types of CLOs would be deemed eligible collateral for a TALF Loan.

Eligibility Criteria for All ABS under TALF 2.0

In order to qualify as eligible collateral under TALF 2.0, ABS must have the following characteristics:

- S. dollar denominated cash ABS (not synthetic);

- 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 eligible, nationally recognized statistical rating organizations (“NRSROs”);
- No credit rating below the highest investment-grade rating category from an eligible NRSRO;
- Issued after March 23, 2020 (other than CMBS, which must be issued before March 23, 2020, and SBA Pool Certificates and Development Company Participation Certificates, which must be issued after Jan. 1, 2019);
- All or substantially all of the underlying credit exposures:
 - Must be newly issued (except for CMBS);
 - For new issue ABS, except CLOs, must be originated by U.S.-organized entities (including U.S. branches or agencies of foreign banks);
 - Must be to U.S.-domiciled obligors or with respect to real property located in the United States or one of its territories^[2];
 - No exposures that are cash ABS or synthetic ABS; and
 - Does not have interest payments that step up or step down to predetermined levels on specific dates.

Eligibility Criteria for CLOs under TALF 2.0

In order to qualify as eligible collateral under TALF 2.0, CLOs must have the characteristics required for all ABS (unless CLOs are expressly excluded from such criteria) and also have the following characteristics:

- The CLO is a static CLO^[3] collateralized by leveraged loans;
- Not backed by commercial real estate;
- An average life equal to or less than 10 years;
- Have a manager that has its principal place of business in the United States;

- All, or substantially all, of the underlying exposures have a lead or co-lead arranger that is a U.S.-organized entity (which includes a U.S. branch or agency of a foreign bank)[4];
- All, or substantially all, of the underlying leveraged loans are:
 - Broadly syndicated loans to large corporate borrowers and/or middle-market loans;
 - Senior secured loans;
 - Originated no later than Jan. 1, 2019 (newly originated leveraged loans may include loans that have been refinanced on or after Jan. 1, 2019);
 - Current on principal and interest;
- Subject to the following portfolio limitations and terms as of the date of the TALF Loan subscription:
 - Maximum second lien loan concentration of 10%;
 - Maximum debtor in possession (DIP) loan concentration of 7.5%;
 - Maximum covenant lite loan concentration of 65% for broadly syndicated CLOs[5] and 10% for middle-market CLOs[6];
 - Maximum single underlying obligor concentration of 4%; and
- The CLO includes at least one overcollateralization test redirecting cash flow from the equity and subordinated tranches to the TALF-eligible senior tranche in the event of deterioration in the underlying loan portfolio.

Additionally, leveraged loans with interest rates tied to LIBOR are generally expected to have adequate fallback language and the CLOs themselves will be expected to have acceptable LIBOR fallback language. [7]

Collateral Valuation for CLOs

Pledged eligible collateral will be valued and assigned a “haircut” according to a schedule based on its sector, the weighted average life and historical volatility of the ABS. If an eligible CLO has an average life from zero to five years, it will be subject to a 20% haircut, and if an eligible

CLO has an average life from five to 10 years, it will have a haircut percentage that will increase by one percentage point for each additional year (or portion thereof) of average life beyond five years.

Pricing and Fees for CLOs

Under TALF 2.0, TALF Loans financing CLOs will be subject to an interest rate of 150 basis points over the 30-day average Secured Overnight Financing rate ("SOFR"), to be paid quarterly. Additionally, CLO borrowers will be subject to a 10 basis points administrative fee assessed against the loan amount on the settlement date for collateral.

Schulte Roth & Zabel will continue to provide updates as further developments become known. In the meantime, please contact your SRZ attorney or one of the authors if you have any questions.

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[1] See

<https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200323b3.pdf>.

[2] "For newly issued CLOs, 95% or more of the dollar amount of the underlying loans in the CLOs must be exposures that are (1) 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) and (2) made to U.S.-domiciled obligors."

[3] A static CLO is "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 disbursement date of any TALF loan secured by the pledge of such CLO. Additionally, a static CLO shall not permit reinvestment of proceeds at any time when the senior-most tranche in priority of payment (or, if the CLO structure includes multiple senior tranches that are pari passu in priority of payment, one or more of such senior tranches) is owned by the New York Fed or by the TALF SPV." Eligible CLOs may permit loans to be sold for cash at their par amount, plus accrued interest, to a sponsor where the cash proceeds are applied to amortize the CLO. CLO managers may sell underlying loans that have defaulted in payment of principal and interest;

however the sale proceeds may not be reinvested and must be used to amortize the CLO.

[4] See footnote 2.

[5] A broadly syndicated CLO is a CLO that does not include leveraged loans of obligors with potential indebtedness of less than \$150 million and permits no more than 10% of the portfolio to be comprised of leveraged loans to obligors with total potential indebtedness of \$150 million to \$250 million. See “FAQs: Term Asset-Backed Securities Loan Facility,” May 12, 2020, “What is the definition of a broadly syndicated CLO and a middle market CLO?”

[6] A middle-market CLO is a CLO that is composed of leveraged loans of obligors, all or substantially all of which have potential indebtedness of less than \$250 million but does not permit the portfolio to include leveraged loans of obligors with EBITDA of less than \$10 million. *Id.*

[7] Note, further that a CLO will not be eligible collateral for a borrower if such borrower or its affiliate is a borrower under a leveraged loan backing such CLO, unless that loan, and each other leveraged loan in the CLO loan portfolio made to an affiliate of the TALF Loan borrower, together constitute no more than 4% of the aggregate principal balance of the leveraged loans in the loan portfolio as of the subscription date.

This is a fast-moving topic and the information contained in this Alert is current as of the date it was published.

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