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April 10, 2020

Legal Update

TALF 2020 and CLOs

On April 9, 2020, the U.S. Federal Reserve announced revised preliminary terms for the Term Asset-Backed Securities Loan Facility ("TALF 2020"). Certain CLO securities that are rated AAA by at least two rating agencies and are not rated below AAA by any other rating agency will be eligible collateral for loans under the TALF 2020 program. In order to be eligible, the AAA CLO securities must be collateralized by static pools of leveraged loans and all or substantially all of these leveraged loans must be "newly issued."

Mayer Brown has separately published an overview of the preliminary terms of TALF 2020;[1] below we highlight several aspects with particular relevance to CLOs. It is expected that the preliminary terms will be supplemented by detailed terms and conditions that may provide definition around some or all of the points discussed herein. This is not an exhaustive summary, and there will be other considerations relevant to CLOs; for example, questions have been raised about the efficacy of the program from a commercial perspective in light of current pricing levels in the CLO market.

Eligibility of Underlying Credit Exposures[2]

The preliminary terms for TALF 2020 require that "all or substantially all of the underlying credit exposures must be newly issued, except for legacy CMBS." While the scope of the requirement that underlying credit exposures be "newly issued" is unclear, it is instructive that in a report to Congress,[3] the Federal Reserve stated that the TALF 2020 program would provide lending to holders of certain ABS backed by "newly or recently originated" underlying credit exposures. This report suggests that the Federal Reserve does not intend for the origination windows applicable to underlying credit exposures in TALF 2020 to be substantially different from those in the TALF program established in connection with the global financial crisis ("TALF 2008"). The terms and conditions for TALF 2008, which at the outset of TALF 2008 used the same "newly or recently originated" formulation with respect to underlying credit exposures,[4] 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.[5]

TALF 2020 will have a greater capacity to provide liquidity to the leveraged loan market if the final terms and conditions for TALF 2020 were to make clear that underlying credit exposures for static ABS (including CLOs) will be eligible to constitute all or substantially all of an applicable portfolio if they were originated in a specified period (not shorter than 12-20 months) prior to the commencement of TALF 2020—consistent with the terms and conditions for TALF 2008—and that underlying credit exposures originated within the specified time frame will be eligible whether purchased in the secondary market or the primary market.

Eligibility of CLO Issuers

The preliminary terms for TALF 2020 require that the issuer of eligible ABS must be a U.S. company, defined as "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."

Although many issuers of U.S. CLOs collateralized by middle market loans are U.S. entities, the vast majority of issuers of U.S. CLOs collateralized by broadly syndicated loans are Cayman Islands entities, frequently with a Delaware-domiciled entity as co-issuer of the AAA tranche and certain other tranches. While it would be possible for U.S. CLOs collateralized by broadly syndicated loans to be structured with a U.S. entity as sole issuer, doing so would result in certain departures from prevailing market practice. We note also that CLO co-issuers are special purpose entities without employees and that a collateral manager is engaged to select the credit exposures underlying the CLO securities. In order to cause as little disruption as possible to the prevailing market approach for providing funding to leveraged loan borrowers via CLOs, it would be beneficial if the final terms and conditions for TALF 2020 were to clarify that a U.S.-domiciled co-issuer qualifies as an eligible issuer if the selection of the credit exposures underlying the ABS is carried out by a collateral manager that is a U.S. entity with significant operations in, and a majority of its employees based in, the United States.

Eligibility of TALF 2020 Borrowers

The requirement that a borrower under TALF 2020 be a U.S. company raises similar questions to those considered above with respect to eligible issuers. TALF 2020 would be most effective in facilitating the provision of liquidity to the U.S. consumers and businesses that are the obligors on the underlying credit exposures if the final terms and conditions of TALF 2020 were to confirm 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.

While these cases may be of varying relevance for CLOs given the historical principal buyer base for AAA CLO securities, in both of these cases there is a meaningful nexus with the U.S. that supports eligibility from a policy perspective, particularly given the U.S. connection that will be required with respect to the U.S. consumers and businesses that are the obligors on the eligible underlying exposures.[6]

We note that the initial term sheet for TALF 2020 expressly included both of the above cases as eligible borrowers, while the revised terms substitute the language quoted above under "Eligibility of CLO Issuers." That new language corresponds to the concept of a United States business under Title IV of the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act"),[7] suggesting that the change in language may have been motivated by a desire for consistency across Federal Reserve stimulus programs rather than any specific intent to exclude the borrowers identified in the deleted language. Therefore we do not view the change as establishing that a U.S. branch or agency of a non-U.S. bank, or a U.S. entity with a non-U.S. parent company, would be ineligible to qualify as a borrower in TALF 2020. We note additionally that there is support in the CARES Act for distinguishing an eligible business from its parent.[8]

Interest Rate Basis

The interest rate for loans collateralized by CLOs under TALF 2020 will be 150 basis points over the 30-day average SOFR. Presumably a factor in the selection of SOFR for this purpose was the fact that the three-year maturity of TALF 2020 loans will extend beyond LIBOR's expected cessation at the end of 2021. Nonetheless, most leveraged loans currently continue to use LIBOR as their interest rate benchmark. To the extent that the use of SOFR as the interest rate benchmark applicable to TALF 2020 loans results in eligible AAA CLO tranches being issued with SOFR as the interest rate benchmark, a basis mismatch would be created relative to the interest rate benchmark applicable to the CLO's underlying credit exposures. While such a mismatch would perhaps have a limited adverse impact on the AAA CLO tranche given the typical quantum of interest coverage cushions in CLOs, the potential adverse impact would increase moving down the CLO capital stack and could therefore be a headwind to the use of TALF 2020 funding in the CLO market.

For more information about the topics raised in this Legal Update, please contact the authors listed below or any other member of Mayer Brown's Banking & Finance and Structured Finance practices.

Ryan Suda
+1 212 506 2581
rsuda@mayerbrown.com

J. Paul Forrester
+1 312 701 7366
jforrester@mayerbrown.com

Keith F. Oberkfell
+1 704 444 3549
koberkfell@mayerbrown.com

Sagi Tamir
+1 212 506 2583
stamir@mayerbrown.com

Joanna C. Nicholas
+1 212 506 2272
jnicholas@mayerbrown.com

Arthur S. Rublin
+1 212 506 2207
arublin@mayerbrown.com

Endnotes

[1] *See* https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2020/04/federal-reserve-revises-new-talf-program-term-sheet.pdf.

[2] We note that the TALF 2020 preliminary terms require that all or substantially all of the underlying credit exposures must have been "**originated by a U.S. company**," in an apparent departure from the TALF 2008 terms which required that all or substantially all of the underlying credit exposures must be "exposures to **U.S.-domiciled obligors**" (emphasis added in each case). Consistent with the TALF 2008 approach, the report on TALF 2020 cited in footnote 3 below refers to "exposures to U.S. borrowers." U.S. CLOs typically require that a specified percentage (typically at least 80% by par amount) of loans in the portfolio consist of obligations of U.S.-domiciled obligors, but U.S. CLOs typically do not impose a requirement with respect to the domicile of the originators of the loans in the portfolio. It remains to be seen whether the final terms and conditions for TALF 2020 will impose any requirement as to the domicile of the underlying obligors.

[3] *See* https://www.federalreserve.gov/monetarypolicy/talf.htm, linking to https://www.federalreserve.gov/publications/files/term-asset-backed-securities-loan-facility-3-29-20.pdf.

[4] *See* https://www.federalreserve.gov/monetarypolicy/files/monetary20081125a1.pdf.

[5] As regards the meaning of "newly issued," we also find it instructive that in the terms and conditions for TALF 2008 published in November 2009, the Federal Reserve considered "newly issued ABS" to include ABS issued on or after January 1, 2009, almost 11 months prior (or even earlier in the case of SBA Pool Certificates or Development Company Participation Certificates, which were considered "newly issued" if issued on or after January 1, 2008). *See* https://www.newyorkfed.org/medialibrary/media/markets/talf/Terms_Blackline_091030.pdf.

[6] It would also be helpful if, consistent with TALF 2008 eligibility, the final terms and conditions of TALF 2020 were to confirm that an investment fund that is U.S.-organized and managed by an investment manager that has its principal place of business in the United States is an eligible borrower.

[7] *See*, *e.g.*, Section 4003(c)(3)(C) of the CARES Act.

[8] *See* Section 4003(c)(3)(A)(ii)(I) of the CARES Act, referring to "the eligible business or any parent company of the eligible business." Similar language distinguishing an eligible business or funding recipient from affiliates or from a parent company is set out in Sections 4003(c)(2)(E) and 4003(c)(3)(D)(i)(VII) of the CARES Act. *See also* "The CARES Act and CLOs" at https://covid19.mayerbrown.com/stimulus-the-cares-act-and-clos/ and "Legal Update on Section 4003 of the CARES Act – Liquidity for Eligible Businesses, States, and Municipalities" at https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2020/03/section-4003-of-the-cares-act-v3-final.pdf.