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Term Asset-Backed Securities Loan Facility

Coronavirus: Advisory

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Introduction

On March 23, 2020, the Board of Governors of the Federal Reserve System (the Federal Reserve) announced that it will establish the Term Asset-Backed Securities Loan Facility (TALF II), as part of a package of initiatives to mitigate the disruptive effect of the coronavirus pandemic on the US economy.[1] TALF II is a credit facility, authorized under section 13(3) of the Federal Reserve Act, through which the Federal Reserve Bank of New York (the Reserve Bank) will commit to lend to a special purpose vehicle (SPV), on a recourse basis, against certain types of asset-backed securities (ABS) that satisfy specified eligibility criteria.

The SPV initially will make up to $100 billion of loans available. The US Department of the Treasury (the US Treasury), using the Exchange Stabilization Fund, will make a $10 billion equity investment in the SPV, and the remaining $90 billion will come from the proceeds of recourse loans from the Reserve Bank.

Certain terms of TALF II are set out in a term sheet that the Federal Reserve published on March 23, 2020 (the Original Term Sheet),[2] and subsequently updated on April 9, 2020 (the Revised Term Sheet).[3] Among other things, such loans (each, a TALF Loan) will (i) have a term of three years, (ii) be nonrecourse to the borrower and (iii) be fully secured by Eligible ABS (as defined below).

[1] See Federal Reserve Press Release, *Federal Reserve announces extensive new measures to support the economy* (Mar. 23, 2020).
[2] See Federal Reserve Term Sheet (Mar. 23, 2020).
[3] See Federal Reserve Term Sheet (Apr. 9, 2020).

TALF II is similar, in concept, to the Term Asset-Backed Securities Loan Facility that the Federal Reserve established in 2008 (TALF I).4 There are, however, significant differences, which we summarize under Key Differences from TALF I below.

In an April 1 letter to Federal Reserve Chairman Jerome H. Powell (the Financial Services Committee Letter), 14 members of the US House of Representatives Committee on Financial Services urged the Federal Reserve to expand the scope of TALF II—including, in particular, by including ABS backed by unsecured consumer loans in the program.5 The Revised Term Sheet does not incorporate this proposal.

Overview

Under TALF II, investors who are US companies (defined below) would purchase ABS that meet the definition of Eligible ABS (defined below). The investors would then pledge the Eligible ABS as collateral for a loan. The amount of the loan would be equal to the par amount of the Eligible ABS, less a specified collateral haircut (see Collateral Valuation below). As described under Pricing below, the rate of interest on a TALF Loan is expected to be lower than the interest earned on the pledged Eligible ABS.

Each investor must use a primary dealer6 (a TALF Agent), to access TALF II. The TALF Agent then will act as agent for the investor.

Based on experience with TALF I, investors may, in many cases, be newly formed funds, established for the purpose of investing in Eligible ABS and participating in TALF II. Those newly formed funds must establish a broker-dealer relationship with a TALF Agent in order to participate in TALF II.

Key Terms

The Revised Term Sheet sets out TALF II's key terms:

A. Eligible Borrowers. All US companies that own Eligible ABS and maintain an account relationship with a TALF Agent (Eligible Borrowers) are eligible to borrow under TALF II. The Revised Term Sheet defines "US company" 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.7

B. Eligible ABS. In order for ABS to be eligible for pledge under TALF II (Eligible ABS):

   1. **Issuance Date**

[4] For a summary of the original TALF program, see *The Federal Reserve's Term Asset-Backed Securities Loan Facility*, FRBNY Econ. Policy Rev. (Nov. 2012).

[5] Specifically, they propose the inclusion of investment grade securities backed by unsecured consumer loans as collateral. The Structured Finance Association has made a similar proposal. See footnote 9.

[6] "Primary dealers" are generally defined as trading counterparties of the Reserve Bank. However, for TALF I, the Reserve Bank included a number of non-primary dealer broker-dealers as TALF Agents. At this time, it is not clear whether non-primary dealers will be TALF Agents for TALF II, or who those TALF Agents will be.

7 The definition of "eligible borrower" closely resembles language used in the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), H.R. 748, 116th Cong. (Mar. 27, 2020), in relation to eligibility for funding under the mid-size business lending program. (See CARES Act, § 4003(c)(3)(D).) Unlike TALF I, the definition of "eligible borrower" does not explicitly include investment funds that are US-organized and managed by a US investment manager. It is not entirely clear how the definition would apply to such entities. Offshore funds (even those with US managers) would appear to be excluded.

(a) Commercial mortgage-backed securities (CMBS) must have been issued before March 23, 2020 (and CMBS issued on or after that date are not eligible).

(b) Any other ABS must have been issued on or after March 23, 2020.

2. **Origination Date**. Except in the case of legacy CMBS, all or substantially all of the underlying credit exposures must be newly issued.

3. **Eligible Asset Class**. The underlying credit exposures must consist of:

   (a) auto loans and leases;

   (b) student loans;

   (c) credit card receivables (consumer or corporate);

   (d) equipment loans and leases;[8]

   (e) floorplan loans;

   (f) insurance premium finance loans;

   (g) certain small business loans guaranteed by the Small Business Administration (SBA);

   (h) leveraged loans (thereby permitting static collateralized loan obligations (CLOs); or

   (i) commercial mortgages.[9]

The addition of other asset classes may be considered in the future.[10]

4. **USD Cash Assets**. The ABS, and the underlying credit exposures, must be US dollar denominated cash assets (not synthetic).

5. **US Originated**. All, or substantially all, of the underlying credit exposures must have been originated by a US company.[11] For CMBS, the underlying credit exposures must be to real property located in the United States or one of its territories.

6. AAA-Rated. The ABS must:

   (a) have a credit rating in the highest long-term (or, in the case of non-mortgage ABS, the highest short-term) investment-grade rating category from at least two eligible nationally-recognized statistical rating organizations (NRSROs); and[12]

   (b) not have a credit rating below the highest investment-grade rating category from any eligible NRSRO.[13]

However, Eligible ABS does not include:

A. ABS with underlying credit exposures that are themselves cash ABS or synthetic ABS;

8 A reference to equipment leases was added in the Revised Term Sheet.

9 Leveraged loans and commercial mortgages were added in the Revised Term Sheet. The Original Term Sheet also included a reference to eligible servicing advance receivables, which was removed in the Revised Term Sheet. In a letter, dated March 22, 2020, to the Federal Reserve Chairman and Steven T. Mnuchin, the Treasury Secretary (the SFA Letter), the Structured Finance Association (SFA) urged the government to include a number of other asset classes.

10 In the Financial Services Committee Letter referred to above, members of the House Financial Services urged the Federal Reserve to include unsecured consumer loans as an eligible asset class; at least for now, the Revised Term Sheet does not do so.

11 "US company" is defined in the Revised Term Sheet. See paragraph A (Eligible Borrowers) above.

12 In the SFA Letter (see footnote 9), the SFA urged the Federal Reserve to treat the highest-rated tranche in an ABS as eligible, even if that tranche is not rated "AAA."

13 The Revised Term Sheet does not define "eligible NRSRO."

B. CLOs permitting substitution (only static CLOs constitute Eligible ABS);

C. single-asset single-borrower (SASB) CMBS;

D. commercial real estate collateralized loan obligations (CRE CLOs); or

E. ABS that bear interest payments that step up or step down to predetermined levels on specific dates.

C. **Reserve Bank Risk Assessment.** The Reserve Bank will perform a risk assessment of any ABS that is proposed as collateral for a TALF Loan and reserves the right to reject any ABS that otherwise satisfies the definition of Eligible ABS.

D. **Collateral Valuation.** The pledged Eligible ABS will be valued and assigned a haircut according to a schedule set out in the Revised Term Sheet.

E. **Conflict of Interest Requirements**. Eligible Borrowers and issuers of Eligible ABS will be subject to the conflicts of interest requirements of section 4019 of the CARES Act.[14]

F. **Financing by Issuer.** The Revised Term Sheet does not specifically address whether an issuer or originator may finance its own ABS under a TALF Loan. We note, however, that under TALF I, Eligible ABS for a particular borrower could not be backed by loans originated or securitized by the borrower or by an affiliate of the borrower.[15]

G. **Pricing.** The interest rate will be:

1. **CLOs**. For CLOs, 1.50% (150 basis points) over the 30-day average secured overnight financing rate (**SOFR**).
2. **Certain SBA Certificates**.
   (a) For SBA Pool Certificates (section 7(a) loans), the top of the federal funds target range plus 0.75% (75 basis points).
   (b) For SBA Development Company Participation Certificates (section 504 loans), 75 basis points over the 3-year fed funds overnight index swap (OIS) rate.
3. **Other Eligible ABS**. For all other Eligible ABS with underlying credit exposures that do not have a government guarantee:
   (a) 1.25% (125 basis points) over the 2-year OIS rate for securities with a weighted average life less than two years; or
   (b) 1.00% (100 basis points) over the 3-year OIS rate for securities with a weighted average life of two years or greater.

   The pricing for other Eligible ABS will be set forth in the detailed terms and conditions.

H. **Fees.** The SPV will assess an administrative fee equal to 0.10% (10 basis points) of the loan amount from the proceeds of the TALF Loan remitted on the relevant settlement date.

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[14] Section 4019 of the CARES Act prohibits businesses in which "covered individuals," consisting of specified senior government officials, and certain of their family members, have (individually or in the aggregate) a 20% or greater equity ownership interest, from benefitting from funds available under the CARES Act. The Revised Term Sheet does not set out in detail how this would apply to TALF II.

[15] An affiliate of a borrower was defined under TALF I as any company controlling, controlled by, or under common control with the borrower. For such purposes, a person or company was deemed to control a company if, among other things, it (1) owned, controlled, or held with power to vote 25 percent or more of a class of voting securities of the company or (2) consolidated the company for financial reporting purposes. See *Term Asset-Backed Securities Loan Facility: Frequently Asked Questions* (Jul. 21, 2010).

I. **Investment by the US Treasury.** As noted above, the US Treasury, using the Exchange Stabilization Fund, will make an equity investment of $10 billion in the SPV.

J. **Non-Recourse.** Each loan made in compliance with TALF II will be limited in recourse to the pledged Eligible ABS and otherwise non-recourse to the borrower.

K. **Prepayment and Substitution.** A TALF Loan may be prepaid, in whole or in part, at the option of the borrower, but substitution of collateral during the term of the loan generally will not be allowed.

L. **Program Termination.** No new credit extensions will be made after September 30, 2020, unless TALF II is extended by the Federal Reserve and the US Treasury.

Key Differences from TALF I

This table summarizes some of the key differences between TALF I and TALF II (as outlined in the Revised Term Sheet):

	TALF I	TALF II
Program Size	$200 billion	$100 billion
Loan Term	Five years for CMBS Three years for all other ABS	Three years
Commercial, Governmental and Rental Fleet Leases	Eligible	Not Eligible
Legacy Assets	Certain exceptions permitted, including assets in master trusts	Except in the case of CMBS, assets must be newly-originated
Borrower-Affiliated ABS	Prohibited	Not specifically prohibited in the Revised Term Sheet
Administrative Fee	0.05% (5 basis points)	0.10% (10 basis points)

Additional Notes

More detailed terms and conditions will be provided at a later date, primarily based upon the terms and conditions used for TALF I. The Federal Reserve has explicitly reserved its right to review and make adjustments to these terms and conditions—including the size of the program, pricing, loan maturity, collateral haircuts, and asset and borrower eligibility requirements—in a manner consistent with TALF II's policy objectives.

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To help our clients navigate the coronavirus (COVID-19) crisis, Arnold & Porter has established a Coronavirus Task Force covering a wide range of issues and challenges. Subscribe to our "Coronavirus (COVID-19)" mailing list to receive our latest client Advisories and register for upcoming webinars.

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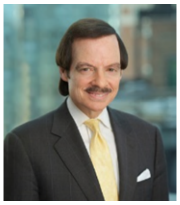

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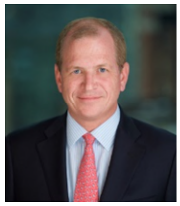

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