Replacement issues

Term SOFR is expected to be the main replacement for US Libor. **Mark Pelham** explores the challenges the new benchmark presents to US CLO equity investors.

The US Federal Reserve's Alternative Reference Rates Committee (ARRC) has firmly backed Term SOFR to replace Libor *(SCI 2 August)*. The new benchmark provides US CLO equity investors with some challenges – challenges that they will need to overcome sooner rather than later, as no new US dollar Libor contracts can be issued after 31 December 2021. Consequently, the first SOFR-related deals will appear long before the final abandonment of Libor in June 2023.

"We've not seen any movement yet, but our sense is we'll see the first non-Libor deals in Q4 at the earliest," says Pratik Gupta, head of CLO/RMBS research at Bank of America. "It is likely to be SOFR-linked issuance, based on how regulators appear to favour it and since ARRC has now formally recommended Term SOFR. That would likely mean SOFR issuance for term loan Bs as well, considering CLOs constitute 65% of the outstanding leveraged loan market."

Daniel Wohlberg, director at Eagle Point Credit Management, suggests that the loan market will make the first move. "We're hearing that regulators are putting more pressure on banks to shift to non-LIBOR base rate issuances before the end of the year. I think the ARRC support for Term SOFR was a positive move in helping to get the ball rolling. While there are still some objections being raised, people are generally starting to coalesce around SOFR, but we really don't yet know for certain what will happen." ▶

Pratik Gupta, Bank of America

He continues: "Certainly from a CLO perspective, it hasn't yet made sense to issue a SOFR based deal – there aren't enough SOFR loans to do that. However, once we see that first really big term loan coming out linked to SOFR and it then starts to happen more frequently, I think CLOs won't be far behind, because managers want to buy new issue. Equally, banks are warehousing in Libor right now, but if they begin to switch to SOFR, managers might want to buy SOFR loans also to match base rates."

With SOFR seemingly inevitable, the benchmark raises its own issues. Gupta notes: "The key concern on using SOFR is around spread adjustments and particularly their impact on equity investors."

ARRC's hardwired fall-back language includes recommended adjustments to be made when switching from Libor to SOFR – 11bp for one-month, 26bp for three-month and 42bp for six-month rates. The decision to go with set levels rather than, say, a six-month average of the spot rates has met with plenty of criticism, but the recommendation stands for now. Further, the recommended adjustments are far higher than the current spot basis between Libor and SOFR – 7bp in the three-month, for example.

"If, at the time of switching, the spread adjustment is too high versus the then current market levels, it is of course open to some equity holders to refi/reset their deals accordingly," Gupta says. "However, for more recent deals with a non-call date ending in October 2023 or later, debt holders might get paid above average coupons for two-to-three quarters."

At the same time, the fall-back language gives loan borrowers the flexibility to switch between different tenors of the reference rate without altering the margin over the reference rate they need to pay. In contrast, CLOs have no alternative but to continue to pay three-month Libor or SOFR plus the adjustment.

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CLOS – THE CURRENT POSITION

There are broadly three types of CLOs outstanding in the market. The 'legacy' Libor contract CLOs, which lack fall-back language and revert to the 'last known option' are very small in number and would likely utilise the ARRC fall-back methodology based on the New York legislation. Following the Libor cessation announcement in mid-2017, the fall-back language in CLOs has evolved with some (a) reverting to the reference rate used by at least 50% of underlying assets and others (b) utilising ARRC's hardwired fall-back language – thus reverting to Term SOFR with the spread adjustment likely to be the one recommended by ARRC (i.e. 26bp). Most new issue deals fall into the latter category.

For both set of deals, a switch is expected to occur slightly before June 2023. The spread adjustment might vary for the former cohort of deals, however, based on whatever the prevailing market spread adjustment is.

Source: Bank of America CLO research

"The fact that the asset and liability waterfalls are different is one of the things that make CLOs unique," explains Gupta. "But equity cashflows could be adversely affected if borrowers start switching to one-month SOFR with a lower spread adjustment when CLO liabilities have to switch to three-month SOFR with a higher spread adjustment."

Nevertheless, Wohlberg suggests that the market will find a way to deal with the adjustment. "If all legacy liabilities moved to SOFR immediately today, equity would lose money due to the current difference between base

LOANS – THE CURRENT POSITION

According to the LSTA & Covenant Review, 20% of the outstanding market includes ARRC hardwired fall-back language. The vast majority of new issue loans incorporate this provision. A small share (7%) include an early opt-in trigger that would allow the borrower to switch to a credit sensitive rate prior to June 2023 if lenders don't object. For such loans, if the ARRC spread adjustment is deemed to be higher than the market rate, borrowers will likely reprice.

The rest of the loan market though (80%) includes Amendment Fall-backs. According to the LSTA & Covenant Review, most of these (60%) require the agent and the borrower to give consideration to prevailing market conditions at the time of amendment when switching the rate.

Many of these borrowers are also likely to refinance in late 2021/2022 and in the process either adopt a non-Libor based index or include ARRC hardwired fall-backs. Thus, loans will likely switch to prevailing market spread adjustments if and when they switch to Term SOFR.

Source: Bank of America CLO research

rate adjustments," he says. "However, liabilities don't necessarily have to shift until 2023 or until enough SOFR loans exist in the market and who knows where rates will be at that point."

Further, Wohlberg adds: "The 26bp adjustment may not apply to new loans; that's really only applicable when you're reverting on a secondary loan or security. Large asset managers

Daniel Wohlberg, Eagle Point Credit Management

will be able to negotiate what the spread or credit sensitivity adjustment actually is in the primary market in real time."

Another issue with Term SOFR is its lack of a credit sensitive component, which Libor has. Consequently, in times of high market stress Libor levels rise rapidly, while SOFR moves slower and less significantly because of the way it is calculated.

As a result, Gupta observes: "Should there be any credit stress in 2022/early 2023, this could have an adverse impact for equity for existing CLO deals with Libor-linked liabilities and a higher share of SOFR-linked assets in 2022. In a credit stress scenario, debt costs could increase as Libor would widen – although coupons on the asset side will remain the same, as SOFR will likely remain relatively low."

Another strong objection to the lack of credit sensitivity in SOFR comes from lenders and regional banks, in particular. "From a regional bank perspective, without large trading desks to manage rate exposure, the lack of a credit sensitive rate can be troubling – now they won't naturally gain more interest as market risk increases innately," says Wohlberg. "We could see a divergence where some banks maybe issue at tighter spreads, but want to use a credit sensitive rate like Ameribor or BSBY even if the broader market uses SOFR generally."

Overall, he remains positive about the switch to a new benchmark. "Nothing is ever perfectly smooth. But as the entire market is driving in the same direction and everyone wants to preserve the spirit of transactions through the change, I'm generally optimistic that while we might have a couple of hiccups on the way, Libor transition should ultimately not be as big an issue as many initially expected."

> "WITHOUT LARGE TRADING DESKS TO MANAGE RATE EXPOSURE, THE LACK OF A CREDIT SENSITIVE RATE CAN BE TROUBLING"

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