Thomas Majewski
Founder & managing partner
Eagle Point Credit Management

Sofr looks like the most likely candidate to replace Libor, but it is still risky to write it into CLO documentation

Libor's replacement as a base rate for the credit and derivatives markets has been considered an inevitability by many for some time. When chief executive of the Financial Conduct Authority Andrew Bailey made his Libor cessation announcement in 2017, the CLO market had already been preparing to handle the coming shift.

Years before this, many CLOs featured provisions for replacement rates. Further, the Federal Reserve's Alternative Reference Rates Committee (ARRC) has long been working on a replacement rate. To that end, the ARRC developed the Secured Overnight Financing Rate, or Sofr, along with procedures for an orderly transition from Libor in 2021.

With the Libor cessation now less than a standard two-year CLO non-call period away, it is the responsibility of the market — CLO debt and equity investors, as well as CLO collateral managers — to make sure the rate transition occurs in an orderly manner.

CLO investors are more than ever focused on the Libor replacement language for CLO debt tranches. Overwhelmingly, CLOs require that the CLO collateral manager implements a base rate that the market accepts as the replacement for Libor (inclusive of any market standard adjustments) if there is a disruption or discontinuation of Libor. Without debt or equity consents, the CLO collateral manager is typically limited to selecting a base rate that is either provided by the ARRC or used by the majority of the loans owned by the CLO.

In sync with loan benchmarks

These options, which are meant to converge over time, reflect an understanding that though regulators should be the guide, the underpinning of CLO issuance is spread arbitrage. Therefore, the base rate used by the underlying broadly syndicated loans should be the direction of travel for all CLOs.

Regrettably, a small number of CLO debt investors have recently begun insisting on 'hardcoded' Sofr replacement provisions within CLOs. These provisions limit the ability of CLO collateral managers to choose a replacement base rate other than Sofr. Until there is clarity from the loan market as to their definitive base rate, we see only risk in such definitive provisions.

It is likely that not all loans will change base rates on the same day. This will lead to minor short-term mismatches between asset and liability base rates within a CLO, which would be similar to the one-month/three-month Libor differential in 2018 — the impact of which is often exaggerated. We don't expect rate mismatches to be a substantive issue for CLOs.

The good news is that Sofr new issuance is accelerating across other fixed income asset types. More than $235 billion notional floating rate instruments have been issued to date referencing Sofr, including a record $55.7 billion in August 2019 alone, according to the Loan Syndications & Trading Association.

Loan market language is lagging behind

Unfortunately, the loan market has so far lagged other asset classes in adopting non-consent replacement language. According to data published by the LSTA, of the new or amended loans issued in June and July this year, only 11% included ARRC-recommended fallback language. Hopefully this pace will accelerate in the coming months.

Beyond the change in rate itself, there has been little development of a market standard approach to adjustments needed for Sofr to align with Libor in both tenor and risk-inclusion (secured versus unsecured). Proposed spread adjustments are expected later this year from the International Swaps & Derivatives Association to aid in providing clarity to investors. These proposed measures cannot come soon enough.

It is critical for CLOs to base the replacement rate on the same rate as the underlying loans. Until we have further clarity from the loan market, any other approach within CLOs could be considered to be putting the cart before the horse. Nevertheless, while there will invariably be some transitional bumps in the road over the next few years, we are confident the market will be able to transition in an orderly manner.

> Regrettably, a small number of CLO debt investors insist on 'hardcoded' Sofr replacement provisions