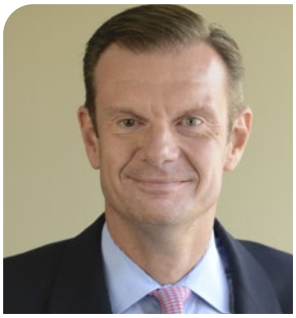

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Sofr may be touted as Libor's natural replacement, but the best known rate in the world is also an option

Ever since Libor began 'acting oddly', in late 2008, CLO market participants have contemplated when it might cease to be published. Cessation of Libor language has been part of CLO documentation for some time.

In late 2017, Andrew Bailey, chief executive of the UK Federal Conduct Authority, announced that the end of 2021 would be the last day Libor was published. Due to the ensuing pandemic, the market was later given a reprieve to the end of 2023.

Despite a tremendous amount of talking and the passage of four years, it feels like we can't yet agree about a replacement — either for CLOs or loans. Why are we still issuing new 12-year CLOs referencing Libor? As a CLO investor, we just want a rate that resets quarterly, is used by both loans and CLO debt, and is generally known and accepted in the marketplace.

Sofr brings more questions than answers

Much of the market's attention has been focused on Sofr as Libor's replacement. As we learn more about Sofr, it feels like we have more unanswered questions than when we started. Will it be daily? Compounded? In advance? In arrears?

While us loan and CLO luddites have stuck with issuing paper off Libor despite the coming cessation, other markets have adopted Sofr, at least to a degree. But we looked into debt issuances in the US municipal market and found that, when we looked under the hood of a Sofr bond, it is more complicated than we anticipated.

One particular bond, issued by the New York Metropolitan Transportation Authority, used a variable rate set each day, as we expected. However, the rate stays flat for three days prior to the coupon payment date so they have adequate time to calculate the exact payment amount. The need for a calculation period is quite reasonable, but this means investors have a daily resetting rate, except for 12 days a year.

We sometimes joke that loans are floaters that don't float — this was due to the floors on rates. But this particular municipal bond is a floater that floats for only 96.7% of the time.

Furthermore, as an investor, if you bought that bond on a standard T-plus-two basis, you wouldn't know what your accrued interest cost would be, as the rate for the day after your purchase wouldn't be known when you agreed the trade with the seller. This could be a significant problem for those managing cash tightly in client accounts.

Agent banks for loans are familiar with many different rates. But they're not particularly familiar with determining rates in arrears. While this may not cause a Y2K-level systemic issue, considering the age of some loan administration systems, it's hard to imagine a switch to a daily, in arrears, rate would be simple to implement. This is a market that still settles loans via fax machines!

IG bonds use a treasury rate

We suspect many regular readers of this column are at least somewhat familiar with the multi-trillion-dollar investment grade bond market — which trades on a treasury-plus-spread basis. Tens of billions of dollars of IG bonds change hands every day based on this convention.

Why can't loans and CLOs simply move to three-month treasury bills as our reference rate? It's a widely known and accepted short-term rate that is traded continuously around the clock — and around the globe. Everyone's systems can handle it and it doesn't require fax machines to settle. And, regrettably, we know it's a rate that is not likely to go away anytime soon.

The biggest negative we've heard is that the liquidity at the short end of the treasury curve is limited. We don't consider that particularly relevant for loans held in CLOs, as few market participants, if any, hedge their rate exposure in loans or CLOs. Many investors seek loans and CLOs because they want a floating rate. Hedging rates isn't a meaningful consideration in either market. Even if an investor did want to hedge, they'd likely seek to hedge the expected life of the instrument they bought (two-to-five years) where liquidity is much greater, not just the next three months.

So it seems that, while the market ponders the complexities of Sofr, there is a simple solution right in front of us. We could have this entire replacement rate debate solved this month — by moving to the best known rate in the world.

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