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The 26bp adjustment is disrupting the transition away from Libor — but market forces will prevail

We are mere weeks away from the end of the London Interbank Offered Rate (Libor) in new issue debt transactions. We have toiled away for years to find the right replacement, deciding a method of calculation and when it should be placed into documentation. It's been hard, but the end is nigh. Time to move on, right?

Not so fast. Despite the 31 December 2021 hard deadline and the market being largely comfortable with Sofr as the replacement for Libor, Sofr loan issuance has been scant and the issuance of CLOs referencing it has been almost non-existent.

What's preventing leveraged and structured credit markets from finally pulling off the band aid to start issuing in Sofr? The answer to this clearly non-mathematical question is a number: 26.

Sofr lacks sensitivity to credit

One of the major differences between Libor and Sofr is that Sofr lacks a "credit spread adjustment," or CSA. Unlike Libor, Sofr has not changed when markets have wobbled, meaning that holders of Sofr-denominated debt might not have received that same pay bump in choppy times that those based on Libor saw.

Initially, many lenders claimed they could not hedge as well against market risks or earn what they felt was a market all-in rate when significant disruptions arose. To address this, authorities focused on how much fixed spread, or adjustment, should be given to compensate debt holders for this difference.

So what is the right adjustment? While investors price credit risk all day long, making a long-term decision about a spread basis between two rates is a decidedly difficult proposition.

Enter the ARRC and Isda. After some consideration, in October 2020, these groups settled on 26 basis points as the default adjustment to move from Libor to Sofr — the average five-year difference between the rates.

On the surface, that seems a reasonable approach. However, spreads between rates can vary greatly if rates are high or low. If you look at Libor or Sofr today, 26bp feels unduly wide.

The market agrees. In one of the first syndicated loans issued that uses Sofr as its base rate, Walker & Dunlop, the market agreed upon different adjustments for different tenors. That loan's interest rate is Sofr, plus 225bp, plus a CSA. In this case, the market said 10bp was the appropriate CSA for a one-month rate, 15bp for a three-month rate and 25bp for a six-month rate. 26bp didn't even make the list. With nearly all CLOs paying on a quarterly basis, it appears the 26bp CSA is 73% above what the market says the fair level is today.

At present, hundreds of billions of dollars of CLO debt will automatically switch to Sofr, plus their stated spread, plus 26bp, once the majority of their underlying loan portfolios are indexed to Sofr.

Perhaps in a high-rate environment that sort of adjustment would make sense. But while we could debate if there will be one or two rate increases next year, in that modestly raised rate environment, 26bp is excessive.

Therefore, we may see more of the remaining Libor-based CLO new issues or resets electing for short reinvestment periods to capture short non-call periods. This would allow those CLOs to refinance away the off-market 26bp adjustment before it kicks in and avoid a situation where debt costs in a CLO increase disproportionately to the increase in asset earnings.

Some CLO equity investors may back away from investing in the primary CLO market until there is greater symmetry between credit spread adjustments for CLO assets and liabilities.

> CLO equity investors have long accepted basis risk... but an off-market adjustment does not work

CLO issuance volumes may also slow further as portfolio managers, or in some cases compliance or legal departments, cease welcoming new-issue Libor denominated debt.

Adjustments will soon normalise

It seems likely there will be a period of mismatch in the market. CLO equity investors have long accepted basis risk, even in a three-month Libor world. Not every loan will change rates on the same day, nor will every CLO. This is fine. Having an off-market adjustment is less fine.

Our belief is that market forces will prevail and these adjustments will normalise reasonably quickly. Our debate today is not about 26bp, it's about when CSAs disappear altogether.