LSTA WEEK IN REVIEW

October 15, 2021

LSTA HIGHLIGHT: Got ESG Q's? We've got ESG A's….here!

PLAYING SOFR-DOKU

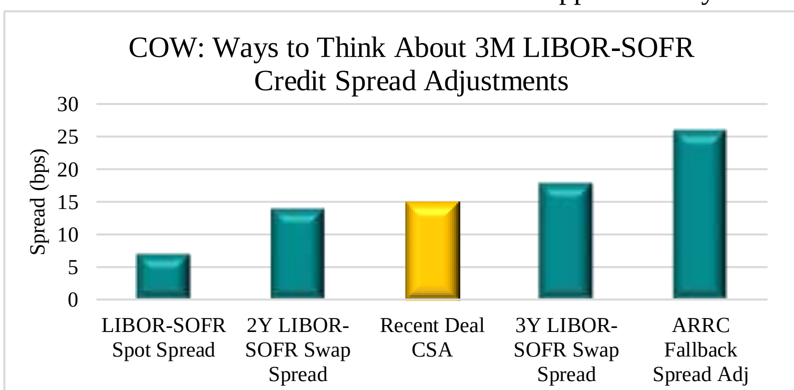
This week, we saw **ARRC exhortations to move off LIBOR**, more SOFR loans emerge and extensive price discovery around the SOFR credit spread adjustment ("CSA"). (We also hear that many investors have started their **CME Term SOFR Licensing process** and urge all others to do so!) Let's drill in.

Last week, JPM launched what we believe was the first Day-One BSL syndicated US institutional SOFR loan: a $600 million TLB for Walker & Dunlop, as reported by **Bloomberg**. This week, **Bloomberg** and **LCD** reported on two additional JPM SOFR deals, one for Traverse Midstream Partners and one for Draslovka Holding.

The spread dynamics of these deals are important; Walker & Dunlop was first reported as SOFR + a flat 10 bps CSA across interest rate tenors + 250 bps margin (SOFR+10+250). In other words, the CSA was flat across one-month, three-month and six-month tenors. This Thursday, **LFI**, **Bloomberg** and **Refinitiv** reported that pricing had been refined to offer a CSA curve – 10 bps for 1M, 15 bps for 3M and 25 bps for 6M.

Some folks have observed that these CSA levels are below the ARRC Recommended Spread Adjustments of 11 bps for 1M LIBOR contracts falling back to 1M SOFR and 26 bps for 3M LIBOR contracts falling back to 3M SOFR. We would note that ARRC Spread Adjustments might not be the definitive comp. While they are certainly informative datapoints, the ARRC did not mean for their fallback spread adjustments to *dictate* new issue spreads. On p. 3 of its January 2020 spread adjustment consultation, **the ARRC stated** that, "It is important to emphasize that any ARRC-recommended spread adjustments are intended for use in LIBOR contracts that have incorporated the ARRC's recommended hardwired fallback language or for legacy LIBOR contracts in which parties are able to and choose to select an ARRC recommended spread-adjusted rate as a fallback. ***The recommended spread adjustments would not and are not intended to apply to new contracts referencing SOFR.*** (emphasis added)."

So how might folks think about credit spread adjustments for SOFR? As we discussed in LSTA **publications** and **podcasts**, the issue is sticky *because today's interest rates are near zero*. Because rates are so low, today's LIBOR-SOFR differential is lower than what we've seen in the past (ARRC Spread Adjustments) and what we may well see in the future (Forward Looking Basis Swaps). This week's COW frames that issue, reviewing various 3M LIBOR-3M SOFR spread differentials. The COW compares today's spot spread differential between 3M LIBOR and 3M SOFR (6.9 bps), the 2Y forward looking 3M LIBOR-SOFR basis swap (14 bps), the Walker & Dunlop 3M CSA (15 bps), the 3Y forward looking 3M LIBOR-SOFR basis swap (17.9 bps) and the ARRC Recommended Fallback spread adjustment for 3M LIBOR-3M SOFR (26 bps). At 15 bps, the Walker CSA is approximately between the 2Y and 3Y LIBOR-SOFR basis swap rates; it is above the spot (which borrowers might prefer) and below the ARRC fallback adjustment (which lenders might prefer).



Source: Bloomberg, CME Group, WSJ, ARRC

We acknowledge that figuring out the spread adjustment is far from easy. (Price discovery seldom is!) However, as KKR's Tal Reback (and co-ARRCist!) noted in Bloomberg, the market eventually figures out where to clear these deals. "That's very healthy, and that's why I think ripping the Band-Aid off now in the fourth quarter allows us to understand how that comes together."

ESG REPORTING: PROGRESS!

Despite the frustration felt by many investors over the availability, reliability and decision-usefulness of current ESG reporting, last week saw two important steps forward in improving the status quo in the private equity market. As **previously reported**, it was

ED – Lee Shaiman (lshaiman@lsta.org); Research - Meredith Coffey (mcoffey@lsta.org), Ted Basta (tbasta@lsta.org), Kenny Riaz (sriaz@lsta.org); Phillip Black (pblack@lsta.org); Legal - Elliot Ganz (eganz@lsta.org), Bridget Marsh (bmarsh@lsta.org), Tess Virmani (tvirmani@lsta.org);.Operations – Ellen Hefferan (ehefferan@lsta.org); Membership – Lisa Schneider (lschneider@lsta.org).

announced last week that Carlyle and CalPERS were leading a partnership of GPs and LPs – the **ESG Data Convergence Project** – to begin collecting and reporting certain ESG data. Two days later a second, different group of GPs and foundations heralded the fruit of their collaboration – **Novata** – a public benefit corporation and technology platform also aiming to improve ESG reporting across private markets.

Novata is backed by a consortium, which includes the Ford Foundation, S&P Global, Hamilton Lane and Omidyar Network, and is designed to offer a vetted ESG reporting framework built around 10 critical metrics that consistently appear across leading ESG methodologies. **As reported by the WSJ,** Novata aims to be a central database for gathering, reporting and benchmarking companies' performance on factors such as carbon emissions, resource management, employee diversity and workplace safety. The **press release** notes that beta customers will have access to the Novata technology platform before the end of the year with broader access planned to be available in early 2022.

While these alliances represent only initial steps to addressing ESG reporting fragmentation, they are certainly very welcome. The LSTA will continue to monitor developments in this space as it **works to improve ESG reporting** in the leveraged loan market.

ARE LOANS SECURITIES, CON'T

Recently, the District Court for the Southern District of NY issued a ruling in *Kirschner v. JPM* that could be very important for the syndicated loan market.

Background. In August 2017, Marc Kirschner, the trustee for the Claims Trust arising out of the Millennium bankruptcy, sued JPM and other banks in connection with the origination and distribution of loans to the debtor. Among the allegations was that the banks violated state and federal securities laws and was based on the premise that term loan Bs are securities. The LSTA filed an **amicus brief** in that case taking the position that loans are not securities and are therefore not subject to the securities laws. JPM filed a motion to dismiss and, **in May 2020, that motion was granted**. However, the court allowed the plaintiff to file a motion to amend its complaint, which it did. Importantly, the plaintiff did *not* seek to amend its securities law claims but reserved the right to appeal that part of the court's decision. Recently, **the court denied the plaintiff's motion to amend the complaint** so the case is over insofar as the District Court is concerned.

Why is this important? Now that the plaintiff has exhausted his options at the district court it is quite possible that he will appeal the entire decision, including the "loans as securities" issue, to the federal Court of Appeals for the 2nd Circuit. We have **written extensively** in the past about the existential threat that treating loans as securities poses for the loan market and it is beyond the scope of this article to address that issue here. If an appeal is taken, the LSTA will monitor the case closely and continue its engagement and advocacy for the principle that loans are not securities subject to state and federal securities laws.

ENVIRONMENTAL JUSTICE, RISK, INVESTMENTS & YOU

On October 5th, the LSTA hosted a webinar, "**How the Emerging Environmental Justice Paradigm Will Shape Risk Profiles and Investment Opportunities**", presented by Crowell & Moring partners, Paul Freeman, Jennifer Grady, Jonathan Kibbe, Elliot Laws, and Kirsten Nathanson. Environmental justice is more than a philosophy or political movement. Environmental Justice is the fair treatment and meaningful involvement of all people, regardless of race, color, national origin, or income with respect to the development, the implementation, and the enforcement of environmental laws, regulations, and policies. It is an easy to grasp and hard to forget concept.

Many environmental decisions of the past were harmful to groups of people who had no way to defend themselves. Today the Biden administration has made environmental justice front and center and is weaving the language of environmental justice into the whole of government approach both with the stick of enforcement actions and the carrot of procurement contracting and infrastructure spending.

The Office of Environmental Justice sits within the Environmental Protection Agency, and it coordinates the EPA's efforts to integrate environmental justice into all policies, programs, and activities. The EPA has been directed to create geospatial climate and environmental; justice screening tools, publish interactive maps annually, generally make real time data publicly available, and strengthen enforcement of environmental violations with disproportionate impact on underserved communities. Environmental justice risk mapping is a mapping tool that tries to combine demographic information, environmental health information, information regarding language and education to determine where the communities are and what risks they are facing. In addition to efforts at the federal level, states continue to develop and build on their existing environmental justice screening and mapping tools. States are adopting laws that promote environmental justice in some way, with New Jersey passing the most far reaching environmental justice legislation in the country.

The Biden administration's approach is moving environmental justice into the real world with concrete impact. As the new paradigm moves forward, the hope is that it will gain traction and shareholder activism and other forces will take hold ensuring it becomes second nature for decision makers to take these environmental justice issues into account.

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