THE LOAN SYNDICATIONS AND TRADING ASSOCIATION

CLOs: Pondering a New Future

May 10, 2018 - As the US market prepares for a potential post-risk retention world, we look back to see what the CLO market has been doing so far this year – and what the future may bring.

Clearly, one thing the market has been doing is deals. According to S&P/LCD, in the year to date, there have been 76 US CLOs bringing $43.3 billion of volume to the US market. This is up from $30 billion in the same period last year. According to TR/LPC's Leveraged Loan Monthly, 2018 refi activity ($9.5 billion) is well down from the $63 billion tracked in the first four months of 2017. In contrast, reset activity has totaled $40 billion this year, up dramatically from the $9 billion in the same period last year. To date, most of the new deals and the resets have been risk retention compliant.

So how do things change in a potentially post-US-risk retention world? First, perhaps obviously, there should be fewer risk retention compliant deals (and fewer US deals choosing to be Euro risk retention compliant, Wells notes). But CLO analysts have not been moving their "new issue" forecasts up much. The reality is that the biggest constraint to new CLO issuance may be limited loan supply. However, analysts feel that refi/reset activity may be higher, as they will no longer absorb precious risk retention capital. If the end of risk retention means more CLO supply – including resets – this could cause upward spread pressure. And, as $19 billion of refis/resets were pushed through on April payment dates, April CLO liabilities did widen.

Widening CLO liability spreads and narrowing loan spreads have been a longtime complaint in the CLO market. But it appears to have been replaced with a new one: Basis risk. More CLO assets (loans) are pegged to lower one-month LIBOR, while CLO liabilities are pegged to the higher three-month LIBOR. This is of heightened interest as it potentially presages issues that could arise from markets transitioning from LIBOR to SOFR.

Recent research from Nomura, Deutsche Bank and Morgan Stanley have dissected the one-month vs. three-month LIBOR problem. Specifically, the basis between one-month and three-month LIBOR widened from less than 10 bps last year to more than 40 bps in March. Nomura reported that by March 60% loans in CLOs were pegged to one- or two-month LIBOR. The problem for CLOs, of course, that their liabilities are based off three-month LIBOR. With the wide gap between the two LIBOR rates, equity returns are being materially clipped.

So what can CLO equity do? First, as Deutsche Bank reports, equity investors would like to have the ability to switch their liabilities to one-month LIBOR if a large proportion of assets are based off one-month LIBOR. CLO debt investors are not fans of this approach and just one or two new deals enjoy this option. Alternatively, Morgan Stanley suggests that equity investors could hedge their basis risk by entering into a swap where they pay one-month LIBOR (plus a spread) and receive three-month LIBOR. Depending on the tenor and shape of the curve, this may be economic.

While this process may be painful, we are encouraged by the discussion because it may be a trial run for when/if the loan and CLO markets transition to SOFR. For those not following the drama, you should know that after 2021, LIBOR potentially will end and be replaced with a new reference rate, the Secured Overnight Financing Rate (SOFR). SOFR (which is a secured, risk-free rate) is expected to be lower than LIBOR (which contains bank credit risk).

To equalize this differential, a LIBOR-SOFR credit spread adjustment (or CSA) likely will be developed.

However, i) a CSA may not be a perfect true-up and ii) it’s possible that starting in the next few years, borrowers might choose to have SOFR borrowing options in their credit agreements. In either situation, CLOs could face a similar basis risk issue. While the CSA should hopefully reduce the SOFR-LIBOR basis risk, we encourage members to watch and learn from three-month/one-month basis process playing out today.