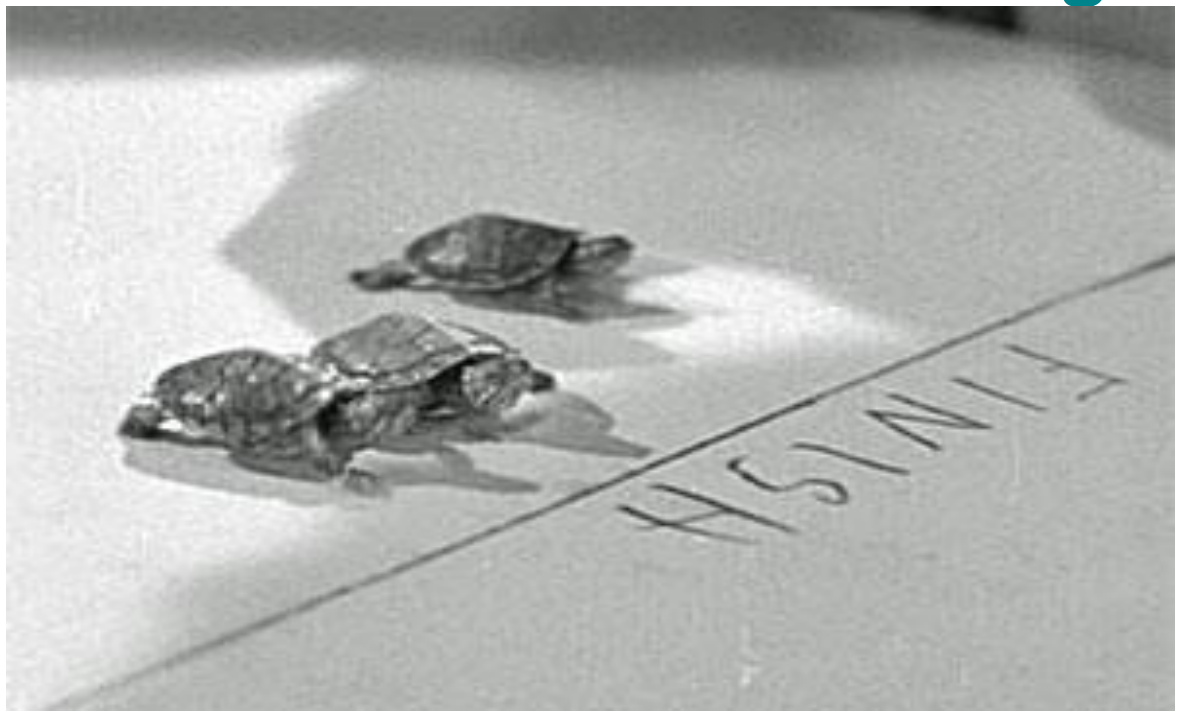
LIBOR Transition:
Loans vs CLOs in the Race Against Time



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Topics

- Myth-busting LIBOR: (ARRC Omnipotence, Legislation's Omnipresence)
- LIBOR: Key takeaways upfront
- Comparing the potential replacement rates
- Implication of LIBOR transition for CLOs

LIBOR Transition: Key Takeaways Upfront

- The USD LIBOR transition is bifurcated. Most USD LIBOR rates will be published and (per the FCA's and IBA's March 5 announcements) continue to be representative through June 2023, but banks will not be permitted to enter into new LIBOR contracts after YE 2021.

- Therefore:
  - USD LIBOR *Origination* by banks ends on December 31, 2021
  - USD LIBOR *Transition* for most legacy contracts not required until June 30, 2023
  - This bifurcation of dates may have implications for CLOs

- Several Replacement Rates are in play in the US syndicated loan market, including Term SOFR, Daily Compounded SOFR, Daily Simple SOFR and Credit Sensitive Rates (CSRs)
  - ARRC and market have made significant progress toward developing a Forward Looking Term SOFR
  - CSR loans (most recently BSBY) are beginning to emerge

- There are economic and operational implications for the different replacement rates

Characteristics of LIBOR vs Potential Replacement Rates

- **USD LIBOR** is a **credit sensitive**, **forward-looking term rate** with seven tenors, including 1M/3M tenors.
- **Credit Sensitive Rates (CSRs)** are calculated using inputs such as CP, CD, bank deposit rates and bank bonds and are correlated to LIBOR.
- **SOFR** is an overnight nearly risk-free rate based on overnight treasury repo. A 1M/3M "tenor" rate is developed by either averaging the rate (in advance or in arrears) or by using a term curve developed by futures trading.

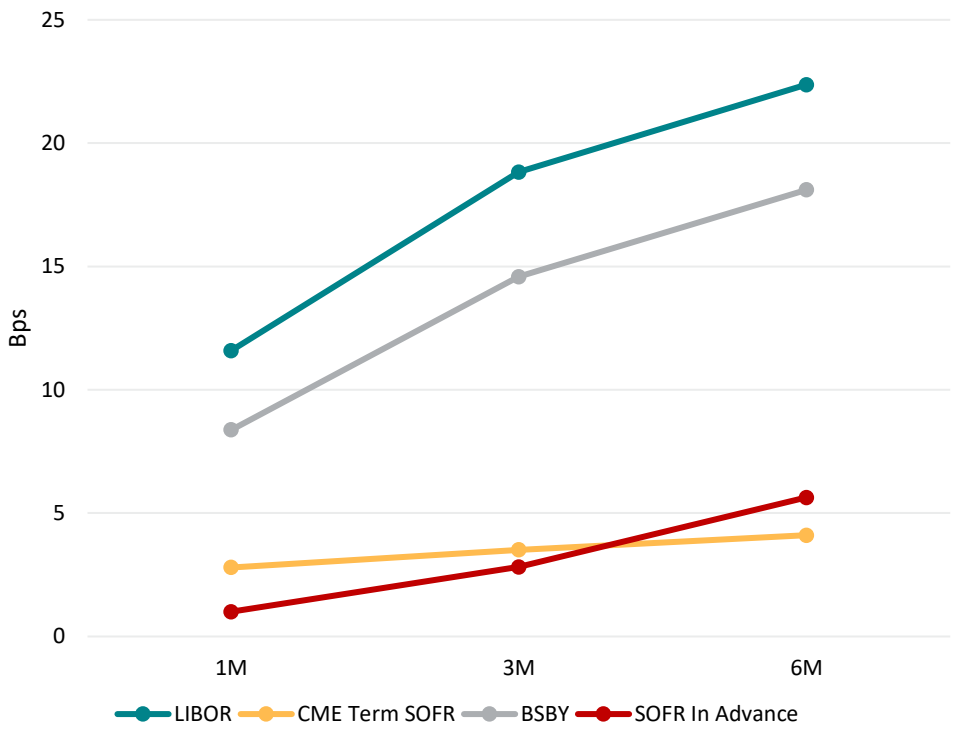
Rate/Characteristic	Known in Advance of Interest Period?	Significant Calculation Required ?	Credit Sensitivity?	Current Use Cases	Strengths/ Weaknesses
LIBOR	Y	N	Y	Nearly all Floating Rate Products	Fragile; LIBOR loan origination ends at 12/31/21
Credit Sensitive Rate (CSR)	Y	N	Y	Loans, potentially FRNs	Nearly seamlessly substitutes for LIBOR in loan & CLO systems; May be less robust than SOFR; May be impacted by Money Market Reforms
Forward Looking Term SOFR	Y	N	N	Used as top step and "flip forward" in Hardwired waterfalls; Used as "flip forward" in Daily SOFR loan agreements	Easily substitutes for LIBOR in loan & CLO systems; CME Term SOFR has been launched, which ARRC will recommend once all indicators have been met; Economically different from LIBOR.
SOFR Compounded in Advance	Y	N	N	Mortgages; RMBS; possibly ABS generally; some business loans	Robust and easily substitutes for LIBOR in loan & CLO systems; Viewed as stale and arbitragable by loan borrowers.
Daily Simple SOFR in Arrears	N	N	N	Some business loans; some FRNs	Robust and relatively easily hedged. Does not substitute easily for LIBOR in CLO & loan systems and conventions, but more implementable than Daily Compounded SOFR.
Daily Compounded SOFR in Arrears	N	Y	N	Derivatives; most FRNs	Robust, very hedgeable. Viewed as challenging substitute for LIBOR in loan & CLO systems and conventions.

Interest Rate Comparisons for LIBOR, CSRs & SOFRs

- The LIBOR and CSR curve should be higher and steeper than SOFR because LIBOR and CSRs have credit risk and SOFR does not

- All the SOFR rates should be very similar, because they are all built around SOFR. Specifically, the reference rate is:
  - Where SOFR *is in the current calculation period (*Daily Simple/Daily Compounded SOFR)
  - Where SOFR *was in the prior calculation period* (SOFR Compounded in Advance)
  - Where Daily Compounded SOFR *is expected to be at the end of the calculation period* (Forward Looking Term SOFR)

Fig. 1: Comparing LIBOR, BSBY and SOFRs (April 2021)



Source: St. Louis Fed, CME, Bloomberg

Rate Implications for Existing CLOs *Before* Liabilities Transition

- LIBOR origination ends 18 months before LIBOR transition for legacy assets; this has implications for existing CLOs

- Before the liabilities in existing (pre-2022) CLOs transition from LIBOR to a replacement rate
  - These CLOs typically will have liabilities based on LIBOR and will initially hold many pre-2022 loans originated on LIBOR; thus, assets and liabilities are initially both based on LIBOR and there's limited basis risk
  - However, over time CLO portfolios may include new loans that should reference a CSR or SOFR; thus liabilities and assets increasingly will be on different reference rates
  - If new loans are based on CSRs, they would be correlated to LIBOR and may introduce less basis risk into CLOs
  - If new loans are based on SOFR, they may be less correlated to LIBOR and may introduce more basis risk into legacy CLOs
  - If new loans reference Daily Simple/Compounded SOFR, this may introduce administrative challenges into legacy CLOs

Rate Implications for Existing CLOs *After* Liabilities Transition

- What happens when the CLO liabilities in existing pre-2022 CLOs fall back from LIBOR to replacement rate?
  - If an "Asset Replacement Trigger" exists in the CLO, the *timing* of when the CLO liabilities fall back from LIBOR will be more correlated to the CLO's assets migration away from LIBOR;
  - If an "Asset Replacement Trigger" is not included in the CLO, the CLO liabilities will not transition away from LIBOR until after June 2023 regardless of LIBOR migration in the CLO's investment portfolio
  - CLOs whose "Designated Replacement Rate" is based on the ARRC waterfall and that do not permit the Collateral Manager to select a different "Alternate Replacement Rate" if either of the first two rates in the ARRC-waterfall are available are expected to fall back to a SOFR rate regardless of the rates referenced by the loans in their investment portfolio (which may be based on i) SOFR, ii) a mix of CSR and SOFR, or iii) mostly CSR)
  - In CLOs whose "Designated Replacement Rate" is based on the ARRC-waterfall but permit the Collateral Manager to select a different "Alternate Replacement Rate" (typically subject to the consent of majority of the controlling class and majority of the equity) it is possible that when the CLO liabilities transition away from LIBOR they will transition to the rate used by the majority of the assets in the CLO
  - The CLO liabilities in CLOs whose "Designated Replacement Rate" is the first available rate under the ARRC-waterfall that is used by a majority of the CLO's assets are most likely to transition to a replacement rate correlated to the rate used by the majority of their assets

LIBOR Transition: Rate Implications for New CLOs

- New CLOs issued after 2022 may or may not follow the reference rate adopted by loans
- If loan market adopts Term SOFR, the CLO liabilities are reference SOFR at issuance
  - In this scenario, the liabilities are aligned with other securitized products and there is no basis risk for CLO equity
- If the loan market adopts a CSR *and* CLO liabilities reference SOFR
  - There potentially is more basis risk that CLO equity must absorb or CLOs must have more robust hedging language
  - CLO liabilities should be aligned with other securitized products (assuming they adopt SOFR)
- If the loan market adopts a CSR *and* CLO liabilities also reference a CSR
  - There is limited basis risk between assets and liabilities
  - CLO liabilities may be on a different reference rate from other securitized products (assuming other ABS adopt SOFR)

LSTA Resources: LIBOR Call, Podcasts, Documents & News