SKADI impact piece

LIBOR Implications for CLOs

TRANSITION
GBP
LIBOR
$800 BILLION
COLLATERISED LOAN OBLIGATIONS
USD
SOFR
EUR
ARRC

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S&P Sample of CLO LIBOR Liability Fallback Provisions

Key Transaction Parties Select Rate (70%)	ARRC (18%)	No Fallback (12%)

Summary:

CLOs reference LIBOR on both sides of the contract.

Estimated $800bn of CLOs outstanding.

Background

When USD LIBOR ceases to be published at the end of June 2023 it will have significant implications for products where both borrowers and investors reference LIBOR. One of the largest of these is Collateralised Loan Obligations (CLOs) - it is estimated there are currently $800 billion of CLOs outstanding, made up of around $600 billion in the US with the remainder in Europe and the UK. The difficulty with amending any language in most legacy CLO contracts is that it will require 100% approval by effective noteholders (per the Trust Indenture Act of 1939), and with an estimated 3,000 obligors and 170 asset managers managing these CLOs, a re-papering of each individual contract will be impossible. It is therefore necessary to look at fallback provisions that exist in legacy and more recent contracts.

Current Fallback Provisions

- CLOs originating before the FCA announcement

Older CLOs could end up converting a floating-rate liability to a fixed-rate one, leading to basis risk.

For CLOs that originated prior to the announcement of LIBOR's eventual cessation, there is often no applicable fallback protocol mentioned in the original documentation. If LIBOR is not available, then the calculation agent is required to request quotations from the major banks and if these could not be obtained, the contracts would use the conditions for a temporary suspension of LIBOR for which they planned, whereby the course of action is to use the last quoted LIBOR. This would essentially convert a floating-rate liability into a fixed-rate liability, leading to basis risk. Wells Fargo data suggests this could be the case for a notional total of $150 billion worth of CLOs.

- CLOs originating shortly after the FCA announcement

Fallback rate determined by Key Transaction Parties.

CLOs issued shortly after the announcement often added provisions to CLO indentures which permitted the collateral manager to select a market replacement rate with the consent of certain holders of the notes – usually a majority of the controlling class (the Key Transaction Parties). This avoids the issue of having to obtain 100% approval and also the floating- to fixed-rate liability present in the older CLOs.

- Current CLOs

A hybrid approach under ARRC.

A growing portion of newer CLOs (due to significant refinancing in 2020) now have an Alternative Reference Rates Committee (ARRC) fallback provision "hardwired" into their terms. This approach specifies a fallback waterfall of replacement rates (SOFR + the relevant ISDA credit adjustment spread) that can be implemented without shareholder consent. However, there is also language within this to allow collateral managers to implement a rate other than this with the consent of the majority shareholders. This hybrid approach allows for some flexibility and minimises the potential for basis risk (which we discussed in our previous Skadi Impact piece on USD Delay).

Litigation risks

ARRC looking to remove litigation risk around transition and provide a safe harbour.

There is a real risk that parties affected by the LIBOR transition may attempt to avoid or modify their contracts using force majeure. In March 2020, the ARRC published a potential response to LIBOR transition and, as the vast majority of contracts are governed by NY Law, is proposing the NY State Legislators adopt a legislative response to its discontinuation and possible transition options. The ARRC stated the proposed legislation would:

(i) prohibit a party from refusing to perform its contractual obligations or declaring a breach of contract as a result of LIBOR discontinuance or the use of the legislation's recommended benchmark replacement;
(ii) establish that the recommended benchmark replacement is a commercially reasonable substitute for and a commercially substantial equivalent to LIBOR; and
(iii) provide a safe harbour from litigation for the use of the recommended benchmark replacement.

LIBOR vs SOFR

A difference in the calculation of the replacement rate.

Moving from LIBOR to SOFR will not be a simple like-for-like conversion as the Alternative Reference Rates (ARRs) will not necessarily be reported in the same way. In LIBOR financing, the interest rate is typically set at the start of each accrual period so both parties know what they will pay and receive at the end of the time period. LIBOR is forward-looking, and unsecured. SOFR, on the other hand, is based on overnight secured transactions, and is backward-looking. There is therefore much discussion on whether CLOs will use daily compounded SOFR looking back over the reference period, what is known as "compounded SOFR in arrears" (this appears to be their preferred methodology) or term SOFR. SOFR data from the NY Fed can be found here.

Conclusion

UK transition to SONIA more advanced than US to SOFR.

With the 05-Mar-21 announcement by the FCA and ICE constituting a "index cessation event", the dates of the 31-Dec-21 and 30-Jun-23 have been set in stone and, although the FCA is consulting on whether to allow a "synthetic" LIBOR to be published after these dates, there is now a concerted push to ensure an orderly transition. In the UK, with the increasing liquidity in the SONIA swap market, the transition appears on schedule, but the complexities and size of the USD market, plus the current illiquidity in the SOFR swap market, means that more work needs to be done. The ARRC has set a target of June 2021 to implement a term SOFR rate that should hasten transition.

S K A D I is an independent consultancy providing advice to the Finance, Mining, Renewable Energy and Shipping Industries. S K A D I 's **LIBOR Transition Team** of complex product experts can assist with the process to help you determine how best to approach the transition.

- Cataloguing of current inventory of relevant contracts
- Valuation of exposure
- Scenario analysis
- Bilateral negotiation

Whether you have yet to consider the transition, are determining how to execute, or would benefit from independent experienced negotiators acting on your behalf, S K A D I can offer help. We would welcome the opportunity for a short introductory call.