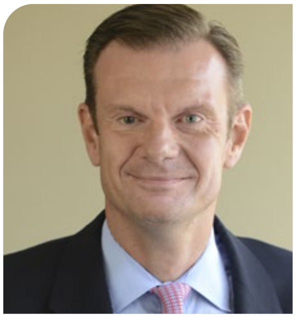

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Market participants smoothed the move from Libor to Sofr — but there is more to be done

It has been over six years since Andrew Bailey of the UK Financial Conduct Authority first announced that Libor would end on 30 June 2023. Now, with that date in our rear-view mirror, we can take stock of a few interesting takeaways from the transition.

Just like Fatcha implementation a decade ago, the CLO market handled this change without pause. From the moment Libor's end was certain, we quickly adjusted terms to consider a base rate change, knowing that even CLO transactions marketing at the time would need to transition pursuant to the proposed timeline.

In summer 2017, the Eagle Point team negotiated new document language two years before the Alternative Reference Rates Committee (ARRC) would provide us all with standardised language (which was then swiftly and broadly adopted). From then on, however, the issues in language differentiation and fears that some CLO market participants would use ambiguous provisions to their advantage grew rampant.

An orderly transition is taking place

Yet, as of today, we are unaware of any CLOs transiting at a credit spread adjustment materially different from the regulatory suggestion, and foresee a substantially complete transition to the Alternative Reference Rate Committee's requirements by the next payment date. Despite some rumours to the contrary, the CLO market is experiencing an orderly transition.

The CLO market has also flexed its muscles against aggressive loan agents and sponsors. Late in 2022, a flurry of cheeky negative consent loan amendments began to arise seeking to transition broadly syndicated loan facilities away from Libor and into Sofr ahead of the 2023 cessation date.

Using the holiday season and a lack of focus at a few too many loan managers, sponsors were able to pass some amendments with credit spread adjustments (CSA) below the regulatory mandated amounts (for example, at flat, +10 or +15 basis points instead of +26.161). This adjustment differential could have resulted in a significant compression of CLO equity returns as CLO debt liabilities transitioned in-step with the ARRC requirements.

Realising that many CLO collateral managers had allowed this to occur, Eagle Point arranged a call with fellow CLO equity investors in January 2023. The CLO equity investor community voiced our objection to CLO collateral managers allowing non-ARRC spread adjustments on loans. A strong and consistent message from CLO equity investors to CLO collateral managers to not rollover in the face of sponsor and agent bank pressures turned the tide, leading to a substantial majority of leveraged loans transitioning at the ARRC-recommended CSA, in step with CLOs.

These outcomes reflect not only the importance of the CLO market to the loan market, but also CLO market participants' ability to collectively and positively affect outcomes for the benefit of all CLOs.

> The pace in which we are seeing remediation today is very encouraging

Next steps for the CLO market

Data flow still needs to improve. As we report to you on these findings, much of what we have to reference has not yet flowed through or is inconsistent in the trustee and service provider records.

For example, how does an investor calculate a CLO collateral manager's loan portfolio spread if some trustees blend the credit spread adjustment into the base rate, while others add it to loan spreads? Typically, investors want to compare spreads independent of the base rate, and always in a consistent manner across providers. We know this will all ultimately work itself out, but the noise adds an unnecessary challenge that requires sifting through by an expert investment team.

At the CLO level, the same difficulties exist. Though amendments have been posted and accepted, the reporting often still highlights the accruals occurring based on Libor, when we know they have transitioned to Sofr.

Candidly, one would hope that, since the transition has been heralded for so long, once adopted, it would flow through quicker. As the leveraged loan and CLO markets continue to grow in participation and liquidity, these operational snags are now more in focus. Ultimately, though, the pace in which we are seeing remediation is encouraging, and Libor will soon be a distant memory.