CLO Insider Newsletter
February 2022

Welcome to **CLO Insider**, a monthly commentary on the CLO Equity Markets from **Mike Kurinets**, CIO of Capra Ibex Advisors and Capra Credit Management.

The leveraged loan market ended January slightly positive (+0.08 points), while CLO liabilities widened on concerns over inflation and subsequent policy responses [1].

This month's CLO Insider addresses key investor questions stemming from the highly anticipated interest rate benchmark transition from LIBOR to SOFR on January 1st.

New-Issue Slowdown in January as SOFR Settles In

Did the transition from LIBOR to SOFR in the new year impact the new-issue market?

New issue volumes were significantly lower in January. **The last time new-issue CLO volumes were so low was in March and April of 2020 when Covid-19 was having its largest impact on the financial markets** [2]. Low January issuance volumes were primarily due to complications derived from the floating-rate index switch from LIBOR to SOFR.

What is the “correct” spread adjustment for floating-rate loans and CLO tranches now that they reference SOFR?

There is an inherent tension between CLO managers (who want lower credit spread adjustments) and CLO investors (who want larger credit spread adjustments). When new CLOs come to market, CLO managers must agree with investors of AAA tranches on what the appropriate credit spread should be. Technically, investors in all CLO tranches, and not just the AAA tranches, need to accept the credit spread adjustment. However, the AAA investors care the most since AAA spreads are the lowest among CLO liability spreads. Therefore, the adjustment in credit spread makes the biggest difference.

Agreeing on the appropriate credit spread was relatively easy when LIBOR was the benchmark. Since LIBOR had existed for many years as the rate at which banks would lend to each other, LIBOR had a credit risk component built into it. Moreover, 1-month, 3-month and longer maturities were well known for LIBOR and a forward curve was well-established.

SOFR, on the other hand, has existed only as a securitized overnight financing rate. As such, it is considered a risk-less rate. In addition, 1-month, 3-month or longer maturities did not exist for SOFR prior to the transition to SOFR in 2022 and SOFR has not historically had a forward curve.

Additionally, spread adjustments tend to be larger early in the process when there is less information available and then tighten as the market adapts and digests the information provided by the first CLOs issued in SOFR. This made CLO managers wary of printing quickly in SOFR, as they were afraid to agree to a wider LIBOR/SOFR adjustment only to see it quickly narrow into the new market standard as the market settles over the next few months.

All of these concerns aside, by the end of January, the CLO market appeared to have quickly settled on an adjustment of around 20 basis points for 3-

month SOFR.

How do CLO equity investors manage the basis risk that arises from the fact that new-issue CLO debt tranches must reference SOFR, while approximately 99% of the leveraged loan market is still linked to LIBOR?

One additional concern for CLO equity investors is the possible basis risk between LIBOR-based leveraged loans and SOFR-based liabilities. However, the market in January largely shrugged off this risk. **Currently, we are not seeing CLO market participants perceive basis risk from the transition as a significant incremental risk for CLO equity investors.**

Footnotes

[1] Based on our cohort of 915 CLOs

[2] S+P Global Market Intelligence

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