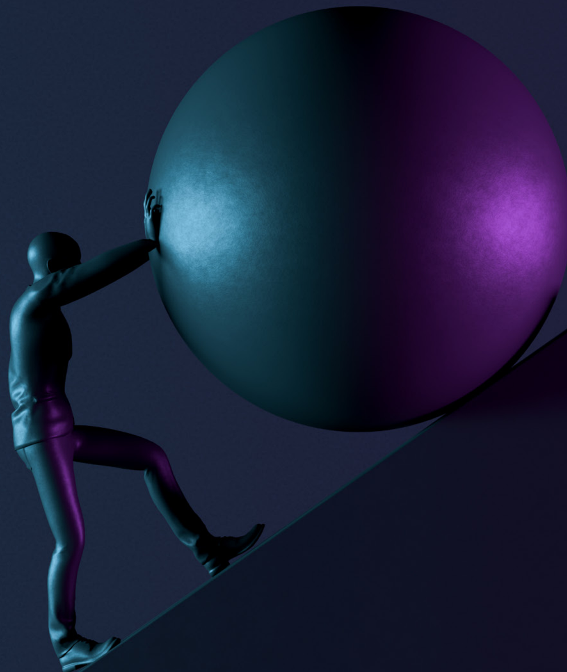
KKR

CREDIT & MARKETS



The Last Six Months of LIBOR: We Don't Have to Live Like Sisyphus

> The struggle itself is enough to fill a man's heart.
>
> –Albert Camus, The Myth of Sisyphus

Written by:

Tal Reback
Leads KKR's LIBOR Transition

Why Market Participants Should Act Now

A little more than a year ago, market participants were preparing for the penultimate step to LIBOR's demise as the deadline for no new LIBOR origination approached on January 1, 2022. In anticipation of this goal, industry, regulatory, and market leaders worked for over a decade to solve the problem of how to thoughtfully unwind over $300 trillion of LIBOR-linked contracts and instruments.

As the clock struck midnight and we ushered in 2022, the eternal optimists of the LIBOR transition looked ahead to new SOFR issuance and market-making; digesting the rate change in capital structures and embarking on the Herculean task of converting legacy LIBOR loans to the new benchmark ahead of a seemingly distant deadline: June 30, 2023.

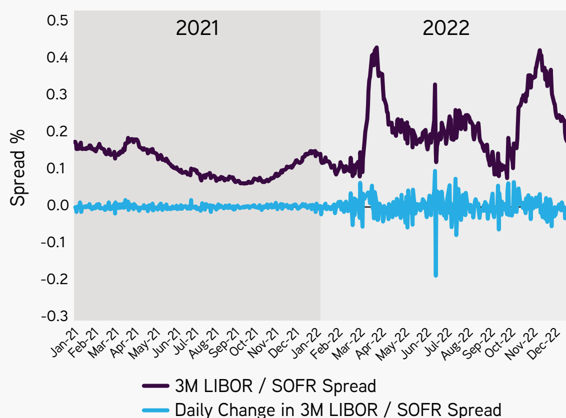
Suffice it to say, the market tumult of 2022, a hawkish U.S. Federal Reserve, and global macroeconomic headwinds put a wrinkle into this plan. Rising rates took center stage in 2022 and will remain in focus until the Fed believes inflation is under control, the labor market has cooled and the U.S. Dollar (USD) weakens. At this time, we believe that the Fed will continue to stay the course and anticipate that the fed funds rate will peak at 5.125%[1] this year, which should be considered when making transition and hedging plans for SOFR.

As of December 31, 2022, only about 21%[2] of the syndicated loan market had transitioned to SOFR, including: 36% of credits trading at par or better with a weighted average rating of BB- and 22% of credits trading between $95–$100 at a weighted average rating of B+.[3] Lower-rated loans have been lagging behind. As 56.8%[4] of the Morningstar LSTA U.S. Leveraged Loan Index is rated single-B and below, the balance of work left lies across loans trading at a discount with higher leverage. This backup in loans also contributes to the delay in CLOs being able to transition, as most CLO vintages are triggered to flip to SOFR once 50% or more of the underlying collateral has transitioned.

The message is clear: We are well behind where we should have been with less than six months left. The consequences of not acting now could be significant for both borrowers and lenders, including:

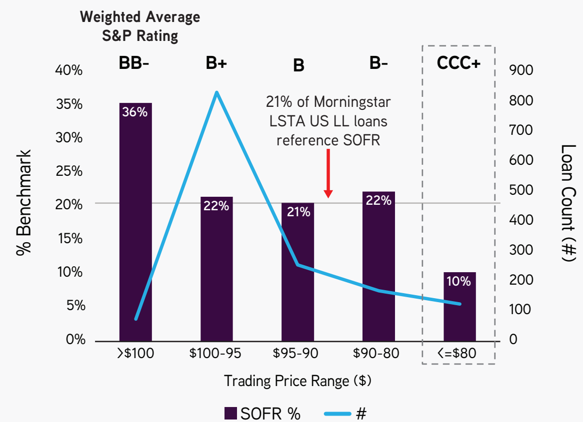
- **Exacerbated LIBOR widening due to illiquidity in LIBOR-linked instruments, which may in turn contribute to stress in asset liability management;**
- **An operational traffic jam at agent banks effectuating amendments; and**
- **The potential use of synthetic LIBOR if loans do not transition by June 30, 2023.**

EXHIBIT 1: LIBOR Spreads and Volatility Increased Dramatically in 2022



Source: KKR Credit & Markets Analysis and Bloomberg as of December 31, 2022.

EXHIBIT 2: Credit Rating and Trading Levels Directly Correlated to SOFR Progress



Source: KKR Credit & Markets Analysis, Bloomberg, LCD, IHS Markit data as of January 9, 2023.

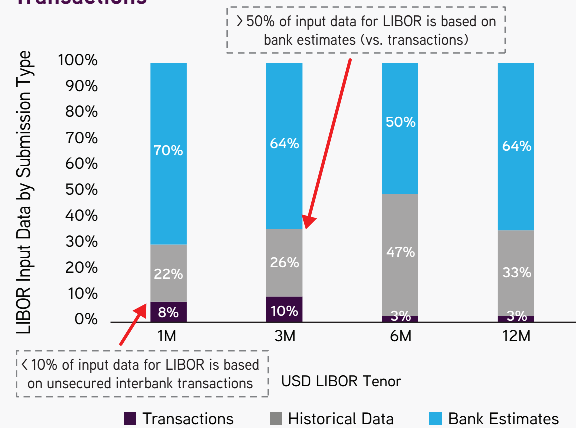
Note: Unless indicated, the above reflects the current market views, opinions and expectations of KKR based on its historic experience and other analysis.
Historic market trends are not reliable indicators of actual future market behavior or future performance which may differ materially, and are not to be relied upon as such.

It is incumbent upon market participants across both sides of the balance sheet to lean in and proactively transition away from LIBOR. As we noted previously, it is time to let go of the past and move forward. Here are the key risks that we see ahead:

LIQUIDITY

Liquidity is the Achilles' heel of the market and is often overlooked when markets are calm, but it is the key to agility and downside protection during volatile times. LIBOR-linked products today are already significantly less liquid than they were in December 2021, and they will continue to become more illiquid, ultimately contributing to widening spreads. Given that banks are no longer making markets in LIBOR, LIBOR quotes are predominantly set by the panel banks and have not been a reflection of credit risk in the market for some time. The scarcity of actual transaction data creates a risk for broader market participants, as it does not provide true pricing depth and increases the probability that LIBOR spreads will widen significantly due to technical factors.

EXHIBIT 3: LIBOR Is Set by Panel Banks...Not Transactions



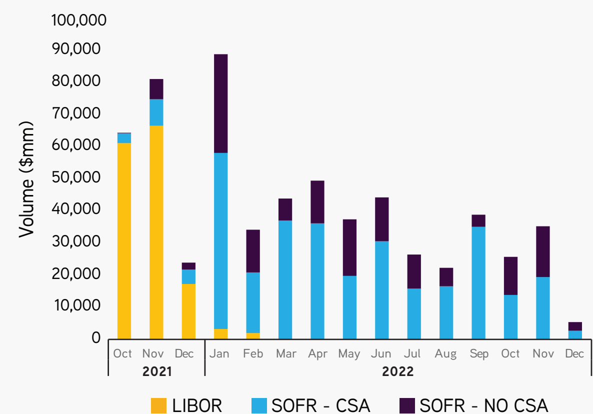
Source: KKR Credit & Markets Analysis, ICE Benchmark data as of December 23, 2022.

AN AMENDMENT JAM

The vast recalibration of risk assets in 2022 and stalled capital markets activity slowed the LIBOR transition (Exhibit 4). Due to the environment, the pace and ability to execute loan amendments declined dramatically as well as suppressed activity to opportunistically refinance to SOFR. Had the market been able to continue to effectuate amendments at a linear pace throughout the second half of 2022, we estimate that over 50%[5] of the loan market could have already transitioned to SOFR (Exhibit 5).

Although many credit agreements contain fallback language to ensure there is a mechanism in place to transition to SOFR on July 1, 2023, we believe that should be treated

EXHIBIT 4: Anemic 2022 New Issue Volumes and Market Volatility Impacted Transition Progress



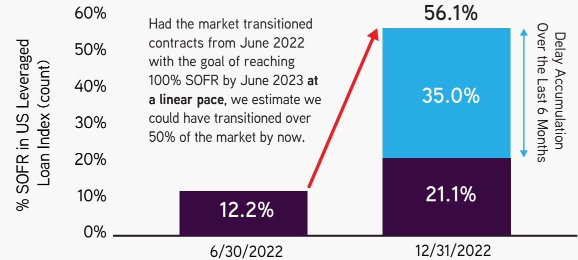
Source: KKR Credit & Markets Analysis and LCD as of December 31, 2022.

Note: Unless indicated, the above reflects the current market views, opinions and expectations of KKR based on its historic experience and other analysis.
Historic market trends are not reliable indicators of actual future market behavior or future performance which may differ materially, and are not to be relied upon as such.

AN AMENDMENT JAM (CONTINUED)

as legal belt and suspenders in the event that there is no opportunity to transition ahead of the deadline. It is important to budget enough administrative and operational time ahead of the deadline to execute these amendments. Many credit agreements call for 5 business day negative consent process to pass the SOFR amendment, and agent banks could face a potential operational traffic jam should market participants not thoughtfully sequence the balance over the coming months.

EXHIBIT 5: If SOFR Transition Had Stayed on Track, it Would Be More than Halfway Done



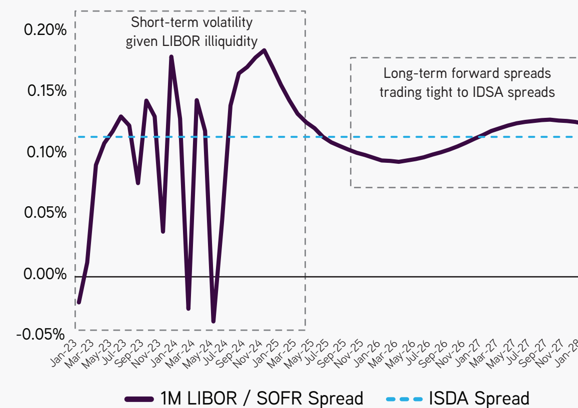
Source: KKR Credit & Markets Analysis and JPMorgan Research as of January 9, 2023.

COST OF CAPITAL AND CREDIT (OR CONVERSION) SPREAD ADJUSTMENT (THE CSA)

Borrowers have had to digest the rapid increase of their cost of capital in a short period of time and lenders have been on the receiving end of rising rates; however, it is incumbent upon both parties to engage in a dialogue to transition to SOFR given the illiquidity risk in LIBOR, the operational risks to procrastinating, and the overall credit health of the debt. Even in the current higher-rate environment, transitioning now can act as a mini-hedge against future volatility.

As a reminder, the Alternative Reference Rates Committee (ARRC) adopted the International Swaps and Derivatives Association's (ISDA) spread adjustment methodology for cash products to be implemented into hardwired fallbacks for existing facilities that will convert to SOFR upon LIBOR cessation. These spread adjustments do not currently reflect market conditions for new transactions. Although many market participants cite the forward curve to derive a CSA, we see this as a circular approach. The LIBOR and SOFR forward curves are calculated using derivative transactions and have already priced in the ISDA spread adjustments (1M 11.4bps, 3M 26.2bps, 6M 42.8bps). Plus, the LIBOR curve is going away, and illiquidity risk skews the picture it paints. As such, the forward curve does not hold much comparative value.

EXHIBIT 6: The LIBOR Forward Curve Is Becoming Obsolete



Source: KKR Credit & Markets Analysis and Chatham Financial as of January 9, 2023.

Note: Unless indicated, the above reflects the current market views, opinions and expectations of KKR based on its historic experience and other analysis.
Historic market trends are not reliable indicators of actual future market behavior or future performance which may differ materially, and are not to be relied upon as such.

LIBOR Legislation and Beware Synthetic LIBOR

The passage of the Adjustable Interest Rate (LIBOR) Act was a tremendous step to create a framework for replacing LIBOR in certain contracts that do not clearly define a replacement benchmark rate. In December, the Federal Reserve Board adopted the final rule[6] that implements the LIBOR Act by identifying benchmark rates based on SOFR that will replace LIBOR for certain contracts governed by U.S. law.[7] The UK Financial Conduct Authority (FCA) is considering the use of a non-representative, synthetic USD 1M, 3M and 6M LIBOR from July 1, 2023 to September 30, 2024 for use in certain legacy LIBOR contracts.[8]

Synthetic USD LIBOR is essentially dressed-up SOFR, plus the respective ISDA fixed CSA per tenor. Whether synthetic USD LIBOR will apply to contracts governed by U.S. law depends on what the individual contract says, including how LIBOR is defined and/or whether there is a non-representativeness trigger. Where synthetic USD LIBOR does not apply and a contract is not transitioning pursuant to the LIBOR Act, there is a risk that an unremediated contract could go to Adjusted Base Rate (ABR) which is typically defined as the Prime rate, 7.5%. Relying on synthetic LIBOR would add unnecessary complexity to an already complex, multi-year transition process. Procrastination or potential reliance on levers such as the use of synthetic USD LIBOR gives rise to litigation risk due to differing interpretations of contracts, prolonged remediation, and potential economic implications. Moreover, it kicks the metaphorical LIBOR can down the road for no good reason.

No Room for Sisyphus

We often to look to Greek mythology for wisdom and find it very relevant here. In many ways, this transition has felt like a Sisyphean task and many of us have spent years, if not more than a decade, solving for the ever-evolving challenges it has presented. Unlike Sisyphus, however, we are not condemned to keep pushing this boulder up a hill for eternity. As prudent students of history, we believe in learning from the past and leaning in where we believe we can help drive a beneficial outcome. We are now nearly at the top of the mountain and on the precipice of the big push. Don't let procrastination or inertia push this LIBOR boulder back down.

1. KKR Global Macro Asset & Allocation Analysis as of January 6, 2023.
2. KKR Credit & Markets Analysis, Bloomberg, LCD, IHS Markit as of 12/31/2022.
3. KKR Credit & Markets Analysis, Bloomberg, LCD, IHS Markit as of 12/31/2022.
4. KKR Credit & Markets Analysis and LCD as of 12/31/2022.
5. KKR Credit & Markets Analysis and JPMorgan Research as of January 9, 2023.
6. Federal Reserve Board Regulation Implementing the Adjustable Interest Rate (LIBOR) Act; Regulation ZZ Docket No. R-1775
7. JPMorgan Research and please note the Final Rule applies to LIBOR contracts that (i) contain no fallback provisions; (ii) contain fallback provisions that identify neither a specific benchmark replacement nor a determining person; or (iii) contain fallback provisions that identify a determining person, but the determining person has not selected a benchmark replacement.
8. UK FCA Consultation on Synthetic US Dollar LIBOR

Note: Unless indicated, the above reflects the current market views, opinions and expectations of KKR based on its historic experience and other analysis.
Historic market trends are not reliable indicators of actual future market behavior or future performance which may differ materially, and are not to be relied upon as such.

Important Information

This document has been prepared solely for informational purposes. This document is not research and should not be treated as research. This document does not represent valuation judgments with respect to any financial instrument, issuer, security or sector that may be described or referenced herein and does not represent a formal or official view of KKR. This document is not intended to, and does not, relate specifically to any investment strategy or product that KKR offers. It is being provided merely to provide a framework to assist in the implementation of an investor's own analysis and an investor's own views on the topic discussed herein.

The information contained herein is only as current as of the date indicated, and may be superseded by subsequent market events or for other reasons. Charts and graphs provided herein are for illustrative purposes only. The information in this document has been developed internally and/or obtained from sources believed to be reliable; however, KKR does not guarantee the accuracy, adequacy or completeness of such information. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be relied on in making an investment or other decision. Opinions or statements regarding financial market trends are based on current market conditions and are subject to change without notice

The information in this document may contain projections or other forward-looking statements regarding future events, targets, forecasts or expectations regarding the strategies described herein, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different from that shown here. The information in this document, including statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. Historic market trends are not reliable indicators of actual future market behavior or future performance of any particular investment which may differ materially, and should not be relied upon as such. This document should not be viewed as a current or past recommendation or a solicitation of an offer to buy or sell any securities or to adopt any investment strategy.

KKR

Kohlberg Kravis Roberts & Co. L.P.
30 Hudson Yards
New York, New York 10001
212-750-8300
www.kkr.com

Twitter: @KKR_Co

Linkedin: /company/kkr

Visit us on **YouTube**