# Floor Plans

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*"The idea that the loan market could trade the floors that exist today for additional spread is pure fantasy." – Beth MacLean, bank portfolio manager, PIMCO.*

It's March 2008. The Fed has dropped rates precipitously to forestall a liquidity crisis. One-month Libor craters to 2.8% from 5% only three months before. Libor spreads for single-B issuers, which had bottomed out at 225 bps in 2007, rise to over 380 bps. Thus did the leverage loan market flip from sell-side to buy-side, and Libor floors took hold.

As the crisis deepened, debt investors demanded a minimum Libor rate, effectively a subsidy boosting their all-in returns. The further Libor dropped below the floor, the more of a premium was earned over the spread itself. By the time Lehman collapsed in September 2009, Libor was near zero. Floors, which had opened as high as 350 bps, settled down to (and have remained) around 100 bps.

Fast forward to today: the Fed's intention to increase rates later this year has investors concerned that issuers will press to eliminate floors altogether. Who needs a subsidy (goes the argument) when actual Libor will soon rise above the floors?

The problem is the interim between when Libor rises, and floors disappear. Debt buyers may get squeezed if they can't recoup rate costs with higher spreads. What if the Fed loosens 25 bps, then sits tight? It could take months before Libor reaches levels floors are at now.

Of course, each asset manager's level of concern depends on rate expectations and funding mechanisms. CLO managers, whose liabilities are Libor-based, worry that if rates rise, so will their costs, compressing equity returns. They hope that by dispensing with floors they will have a good argument to demand higher Libor spreads.

The flaw with that logic is that lenders will jockey for any advantage in a hyper-competitive market. Lower floors dipping below 100 bps have been on offer for some time, and spreads are not widening, at least not for broadly syndicated loans.

For the middle market, floors may be stickier, in part because large deal terms are more subject to market swings than those of club transactions. Also, as we discussed last week, midcap loans are less exposed to mark-to-market drive-by re-pricings.

Memories of 2008-09 are still fresh in the minds of market players. Having witnessed so much rate volatility, investors and issuers alike seek to maximize their future optionality.

We think everyone should be rooting for more normative Libor levels. Modestly rising rates would point to a much healthier recovery than we've had so far. That should prove to be good for all assets, regardless of which side of the floor you're on.