Insights

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SOFR: A Transition from LIBOR

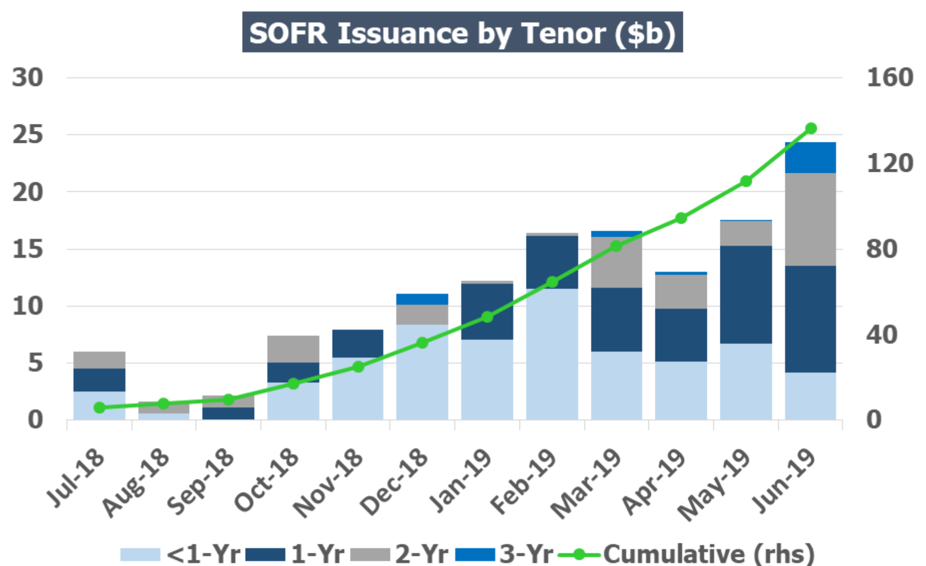
Due largely to recent LIBOR manipulation scandals, regulators in the US are set to phase LIBOR out by the end of 2021 and replace it with the Secured Overnight Financing Rate (SOFR), pressuring market participants to quickly understand and adopt SOFR (refer to our Market Commentary "Onward and Upward"). To recall, SOFR is a broad Treasury repo financing rate that is derived from overnight secured funding transactions. This means that SOFR is fundamentally different from LIBOR for three key reasons: 1) SOFR is a secured rate, while LIBOR is an unsecured rate; 2) SOFR is an overnight rate (resetting the reference rate daily), while LIBOR represents interbank funding over different maturities; and 3) SOFR is a market/transaction based rate, while LIBOR is compiled from bank submissions that were discovered to be susceptible to manipulation from the banks' traders.

The Alternative Reference Rates Committee (ARCC) published in April 2019 their final recommendations for transitioning floating rate instruments away from LIBOR by providing proper contractual fallback language, as the contracts for most legacy floating rate debt never contemplated the cessation of LIBOR. The recommendations consist of a robust "user's guide" instructing issuers how to incorporate triggers to signal when base rates effectively change from LIBOR to SOFR; define the calculation for SOFR; and implement spread adjustments to make the SOFR-based floating rate equivalent to the LIBOR-based floating rate.

Although SOFR trades relatively close to fed funds, it is quite volatile with noticeable spikes at month and quarter end due to increased demand for cash—differing from its predecessor LIBOR which is comparatively steady. Nonetheless, the volatility is inconsequential for most notes currently tied to SOFR because the base rate resets daily, resulting in an averaged SOFR over the interest period, unlike LIBOR-based notes where the base rate is the current 1-month, 3-month, or 6-month tenor depending on interest payment frequency. Further, the spikes have tended to last only one or two days at most. The daily average SOFR is then added to a spread, and the sum is the periodic interest rate the borrower ends up paying.

To date, just 27 institutions (primarily agencies, insurance companies and banks) have issued floating rate debt tied to SOFR totaling approximately $136 billion, including a record $24 billion in June. This pales in comparison to the nearly $1 trillion of debt tied to LIBOR issued during the same timeframe.

Although LIBOR is still the most popularly used floating rate, development of a SOFR term structure computed using forward-looking rates based on SOFR futures could make issuing floating rate debt linked to SOFR even more attractive as issuers could match the SOFR tenor to the interest payment frequency of the notes—thus increasing SOFR volumes relative to LIBOR volumes during the phase-out period.



Source: CME Group