THE LOAN SYNDICATIONS AND TRADING ASSOCIATION

SOFR: Terms of Endearment

August 1, 2018 - SOFR – the potential risk-free replacement rate for LIBOR – has made a number of strides in its short life. The Federal Reserve Bank of New York (FRBNY) began publishing SOFR, which is the combination of three existing risk-free reference overnight repo rates, in early April. In early May, the CME began trading SOFR futures. Because cash market participants require a term reference rate (as opposed to an overnight one), in mid-July, the Alternative Reference Rates Committee (ARRC) published an "indicative" indicative three-month SOFR. But is it possible that cash markets don't actually need a term SOFR? Last week, Fannie Mae issued $6 billion of bonds tied to overnight SOFR. We recap these developments below.

First, as ARRC-ficionados know, the FRBNY began publishing SOFR on April 2, 2018 with an initial overnight rate of 1.8%. Since then, SOFR has moved in a band ranging from 1.65% on the low side (on May 22nd) to 2.12% on the high side (on June 29th). In general, SOFR widens around quarter-end as demand fluctuates, and it has generally been above overnight LIBOR.

But, again, this is an overnight rate. In early May, the CME began trading SOFR futures and futures markets should permit the development of a SOFR term curve. And, indeed, on July 19th, an "indicative" indicative three-month SOFR was published at the ARRC public roundtable (see slide 6 here). Three month indicative SOFR has varied between 1.9% and 2%, thus 30-40 bps below LIBOR.

The cash markets – such as loans, FRNs and securitizations – were cheered by the unveiling of a three-month rate; the prevailing view in the cash markets is that borrowers and lenders need to know the rate at which they are borrowing or lending – and thus a term rate is necessary. And, in turn, developing a term rate has been high on the ARRC's agenda. But recently, several issuers have issued bonds referencing overnight reference rates. In late June, the European Investment Bank (EIB) issued a £1 billion bond using overnight SONIA as the reference rate. (SONIA is the overnight replacement rate for sterling.) It saw £1.5 billion of demand and priced at 35 bps over compounded SONIA, wrote the FT and Risk.net.

Then on July 26th, the first SOFR bond was issued. Fannie Mae issued $6 billion of SOFR bonds, divided into six-month notes priced at SOFR+8 bps, 12-month notes priced at SOFR+12 bps, and 18-month notes priced at SOFR+16 bps. While SOFR is an overnight rate, the pricing supplement explains that the interest payments are quarterly and the reset period is daily. Interest is calculated by multiplying the principal amount of the notes by an accrued interest factor (which is each day's (SOFR+spread)/360), then totaling the interest factors for all the days in the interest period. In effect, it's an average daily rate. Thus, at the end of the interest period, the borrower has paid exactly the real daily rate of interest during the preceding period. However, the borrower and the lender do not know exactly the rate of interest paid at the start of the period. We asked Fannie Mae if not knowing the exact interest rate until the end of the period (and calculating it daily) was an issue. They said it was mostly a non-issue. In fact, they added that this is how Fannie Mae's Fed Fund Floaters work, and so investors actually are used to the convention. In turn, Fannie Mae – and the note investors – did not need to make many operational changes to use an average daily rate for a quarterly interest payment. And, bottom line: With this new $6 billion bond, 87% of Fannie Mae's FRNs are now linked to SOFR; more governmental agencies are expected to follow, Risk.net added.

There was one final advancement in July: Following the Fannie Mae issue, on July 30th, S&P approved SOFR as an "anchor money market reference rate" in its principal stability fund ratings methodology. In effect, this has paved the way for money market funds to more easily invest in SOFR cash instruments, Risk.net added.