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This Libor Successor Is Growing Up, But Still Hasn't Come of Age.

- **Secured Overnight Financing Rate has made headway with GSEs**
- **But wider adoption elusive as market awaits term structure**

Happy birthday, SOFR. It was one year ago that the Federal Reserve Bank of New York debuted the Secured Overnight Financing Rate, seeking to create a new global benchmark for dollar-based funding and ultimately put the much maligned London interbank offered rate out of its misery.

No one ever said it was going to be easy. Yet few predicted the reference rate's growing pains would be quite so, well, painful. Two weeks after its introduction, the New York Fed disclosed it made errors calculating the rate. More recently, it's faced renewed scrutiny amid greater-than-expected volatility, especially around month-end.

That's not to say it hasn't had its successes either. Futures and swaps trading continues to gain traction. And some bond issuers have successfully sold securities linked to the rate. But if SOFR is ultimately going to replace Libor, it still has a lot of work to do.

More than anything, market participants remain hesitant to commit resources to SOFR when there's a chance that Libor's administrator and the panel banks that determine its setting could keep the old rate alive past 2021, when global regulators intend to sound the death knell for the scandal-plagued benchmark.

For a story looking at various alternatives to Libor, click here.

"The market has done very little to curb or meaningfully slow its exposure to Libor," said Jonathan Cohn, the head of interest-rate strategy at Credit Suisse Group AG in New York. For clients the transition to SOFR "is one of interest, not yet action."

Here's the state of play as SOFR turns one.

What's Working

- Trading in one- and three-month SOFR futures continues to grow. Aggregate open interest across both contracts was roughly 149,000 as of March 19, before dropping modestly at the end of the month.
- Swaps transactions tied to SOFR had roughly $13.1 billion of notional value in March, according to Swap Data Repository figures. That was almost double the $6.9 billion traded during the entire month of January, itself a record at the time.
- Organizations have been issuing SOFR-linked debt since July, with sales dominated by government-sponsored entities such as Fannie Mae and the Federal Home Loan Banks. Supranational institutions, banks and municipalities have also sold debt tied to the benchmark, with Credit Suisse estimating that offerings to date have totaled around $79 billion.

What's Holding It Back

- SOFR has shown a tendency to jump at the end of each month since December, when it rose by almost 70 basis points in the second half of the month to finish 2018 at 3 percent. These moves have been spurred by primary dealers pulling back from the market at points when they need to get their balance sheets into shape for regulatory purposes. The rate spiked to 2.65 percent at the end of March, but has since pulled back to 2.46 percent.
- Even though GSEs and financial issuers have started to sell SOFR-linked debt, companies outside the financial-services industry have yet to enter the market. Given that new non-financial corporate bonds tend to price with larger credit premiums, it suggests that greater clarity around SOFR is needed before riskier issuers begin to embrace the rate.
- There is still a lack of clarity from regulators themselves surrounding the transition away from Libor, and hence uncertainty for any potential heir, including SOFR. The Alternative Reference Rates Committee, which has been tasked with developing and implementing SOFR, has released proposals for fallback language that could be included in documentation for Libor-related loans and securities, but final recommendations are still pending.
- Market participants are also awaiting the creation of an indicative term structure, which officials had said would be introduced some time in the first quarter. While there's no term rate as of yet, the January Federal Open Market Committee meeting minutes showed that New York Fed staff have begun work aimed at publishing a series of backward-looking average rates as a way of supporting benchmark reform. Separately, Fed staff issued a paper in February about inferring term rates from SOFR futures prices.

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