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S&P: SOFR Emerging As Alternative To LIBOR In U.S. Debt Markets

Key Takeaways

- SOFR has emerged as the leading rate to replace dollar LIBOR, which is now scheduled to phase out for new-issue transactions by December 2021 and for most legacy transactions with active maturities by June 2023.
- Based on data from the Federal Reserve Bank of New York and earlier repo transaction data since the late 1990s, SOFR has been tracking closely with dollar LIBOR.
- The historical time series analysis between the two benchmark rates shows a positive average and median of LIBOR over SOFR.
- Because only daily SOFR rates currently exist, compounding is typically used for this new rate and helps smooth out most of the volatility in daily rates.

Following the July 2017 announcement by the U.K.'s Financial Conduct Authority that the London Interbank Offered Rate (LIBOR) cannot be assured following 2021, there has been significant discussion around replacement benchmark rates in financial markets. A recent consultation published by the ICE Benchmark Administrator and supported by the U.S. Federal Reserve has proposed to continue dollar LIBOR quotes for the most actively used maturities on legacy transactions until June 2023. Furthermore, U.S. bank regulatory agencies have recently stated that banks should stop using dollar LIBOR in new contracts "as soon as practicable" and, in any event, by Dec. 31, 2021. For U.S. debt instruments (including structured finance securities) with dollar LIBOR exposures and maturities beyond 2023, this will mean changes to benchmark interest rates. While market participants are working to build provisions for alternative benchmarks in new transactions, one source of continued uncertainty centers around legacy transactions where fallback language varies widely.

In the U.S. the Federal Reserve Bank of New York ("the Fed") has developed, and is now publishing on a daily basis, the Secured Overnight Financing Rate (SOFR). Although there are a number of differences with LIBOR, this near-risk-free rate has been viewed by many as the leading replacement rate in U.S. financial markets for dollar LIBOR, similar to how the Sterling Overnight Index Average Rate (SONIA) has been a replacement rate for Sterling LIBOR in the U.K. While SOFR has been published since April 2018, the Fed has released a longer time series, from August 2014 to March 2018, with modeled pre-production estimated data on SOFR that now underlie the official rate publication. Outside the U.S., central banks and financial market authorities have also been charting courses toward new replacement benchmarks set to become active by 2021.

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