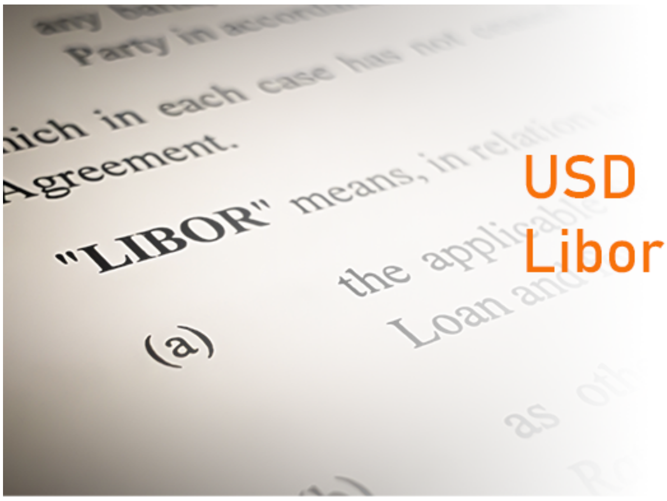
Keeping SOFR pure and simple

The purest form of risk free rate is an overnight one. And to keep it simple, any future rate should be computed as a sequence of realised daily rates. The alternative, is to guess where the rate will be, in say 3 months; which in effect is a term rate. Such US terms rates are still coming. But with a significant delay, causing quite some angst in certain quarters



The ARRC decides to abandon the push for SOFR term rates - big decision!

The Alternative Reference Rates Committee (ARRC) in the US has significantly softened its target to make term Secured Overnight Financing Rates (SOFR) available.

There had been an implicit expectation for the term rate to become available at some point in 3Q21. Now, the ARRC is suggesting that it might not come in 2021 at all.

> What are term rates? In the US the 3mth rate is the benchmark, and a 3mth term rate would be a prediction for the path of overnight SOFR for the 3mths ahead, rather than waiting for 3mths and then see where that compounded in arrears rate will be.
>
> For some players, they ideally need to have term rates as they need to use that to discount future obligation now (just as they do currently with Libor). For most, it matters less, as the

in-arrears methodology is generally workable.

Why does this matter? A sizeable rump of players are massively disappointed on this delay, and are left with key decisions to make on what to do, as the push remains to switch all new business to SOFR by end-2021.

This is a massive setback for a small but a not insignificant rump of players that have been expecting SOFR term rates; typically borrowers in the trade finance and working capital space, to manage their liquidity well.

In the UK, where Sonia terms rates are available, the take-up is running in the area of just under 10% of volumes. While that implies over 90% of new volumes will be in Sonia in arrears, that still leaves a sizeable sub-section that would be un-catered for if we extend these proportions to the US.

So why has the ARRC taken this stance, and does it matter? It does and it doesn't

The logic for the ARRC's reluctance to accelerate efforts to get a SOFR term rate is centered on two points. First, development of a term rate was always contingent on having suitable volumes built in SOFR futures and derivatives, and the ARRC has concluded that such volumes are not in evidence as of yet. And there is an implied presumption that such volumes may not build adequately and in a timely manner in the coming months. Second, and related to this, the ARRC is keen not to fall short of suitable volumes, to avoid legitimacy pitfalls that Libor fell into.

> *"The ARRC is urging participants to push ahead without a term rate. There is an underlying pressure for market participants to look for alternatives to SOFR term rates, and for any future term rates that might eventually come to be used in limited cases."*

To this end, the ARRC is urging participants to push ahead without a term rate. There is an underlying pressure for market participants to look for alternatives to SOFR term rates, and for any future term rates that might eventually come to be used in limited cases. This stance has been supported by various Fed studies that show a minimal basis between SOFR in arrears versus SOFR in advance for shorter tenors (e.g. 1mth). However, SOFR in advance is not the best predictor of SOFR in arrears for longer tenors (e.g. 6mths).

For most players in both loans and derivatives markets, the lack of a term rate is not debilitating. The swap derivatives market was always and will continue to be based off a SOFR in arrears structure.

Partly in consequence, the loans market will have a very similar structure, where the preference is to have so-called "Daily simple" as a reference, where the SOFR rate is applied on a daily basis. In arrears and daily simple are similar. Both are in arrears rates, the only material difference being an implied averaging rather than a compounding computation in the classic in arrears computation.

Who is affected, and what can they now do? Use something else most likely

But what about players that had been holding out for SOFR term rates?

The implied suggestion from the ARRC is to use something else. There are Federal Reserve published SOFR indices that could be employed. Not ideal for longer tenors in trade finance (say out to 12 months), but at least a usable reference. As an aside, a similar implied solution is suggested by the Swiss authorities, which have stated for some time that they will not have a term rate available, ever.

> *"While this is not a debilitating development per se, it is quite unwelcome in the arena of supply chain financing. Either these players will need to significantly change the way they operate, or to use what they would describe as a sub-optimal solution rate."*

While this is not a debilitating development per se, it is quite unwelcome in the arena of supply chain financing. Either these players will need to significantly change the way they operate, or to use what they would describe as a sub-optimal solution rate (even "in advance" rates are technically calculated from historical rates). While this is a minor aspect of the market, unease here does not help against a backdrop where there is an ongoing push from the official sector to switch to SOFR-linked business this year.

The counter argument is this news removes a waiting game that had been ongoing.

The ARRC has now clearly advised those waiting for term SOFR to proceed without it, for 2021 at the very least. While disappointing for players that were waiting for SOFR term rates, the urgency now is transformed to moving on, and employing whatever alternatives are available.

The frustration is that this news, if it was coming, did not come earlier, so that such players could have readied themselves earlier too.

In fact, there is merit in such frustration. The fact that the ARRC had sent out requests for proposal for parties to come back with suitable term SOFR compilations had led most to believe that a term rate would be available. Furthermore, those that require such rates up front as a discounting mechanism had allowed themselves to believe that they could rely on this. That is no longer the case.

This obstacle can create opportunity. It will have to, as the clock is still ticking. Legacy USD Libor has a delay to mid-2023, but all new Libor business (including USD) must still come to a conclusion by end-2021.

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