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SOF(a)R So Bad: A Painful Experience for End Users in the LIBOR/SOFR Transition

Heavy is the head that wears the crown

- Henry IV by William Shakespeare

SOFR's ascendancy to the reference rate throne may be a pyrrhic victory as a significant structural impediment is forcing end users to pay a wider spread to fix out term-SOFR based liabilities. This problem is likely to worsen unless there are significant changes in the current regulatory and clearing regimes to liberalize the trading and clearing of term-SOFR swaps.

The King Is Dead. Long Live the King!

As LIBOR's phase-out in June 2023 approaches, regulators in the US have forbidden the use of LIBOR in loans and derivatives except in rare legacy cases. Swap activity has effectively shifted over to SOFR. But all is not well in the kingdom of SOFR - the Wall Street Journal noted recently that investors are demanding higher spreads on loans to switch from LIBOR to SOFR[1]. This article highlights a different problem in the SOFR transition - an increasingly unbalanced market that penalizes issuers wishing to fix their term-SOFR liabilities. Others have taken note of this issue in the past[2], but with no changes in the offing and the end of LIBOR approaching, the market imbalance is only going to worsen.

The Problem

1. SOFR is an overnight rate that was favored by the regulators as a LIBOR replacement because there is significant overnight repo activity to substantiate the rate. There is much less term-repo activity to support a term-repo based benchmark. Regulators therefore proposed overnight SOFR as the new reference rate.
2. LIBOR transition mechanics only define a fallback methodology and spread to move from term-LIBOR to *overnight* SOFR. It does not define a spread or a fallback mechanism to move from term-LIBOR to term-SOFR since term-SOFR is not the preferred transition rate.
3. By default, LIBOR floating rate notes and LIBOR swaps would transition to overnight SOFR.
4. However, many floating rate investors are demanding term-SOFR rather than overnight SOFR.
5. Corporate issuers are forced to restructure existing loans or issue new loans using term-SOFR as the floating rate (rather than the default overnight SOFR) in order to placate buyers.
6. On their existing swaps against the newly-restructured loans, corporate issuers need to receive term-SOFR (rather than overnight SOFR) and pay fixed on a swap in order to fix out the risk of their floating rate debt.
7. Swap dealers face substantial demand from users asking them to pay term-SOFR.

[1] "Companies, Lenders Clash Over Loan Spreads in Switch from LIBOR", Mark Maurer, Wall Street Journal, 13 Jan 2023

[2] "SOFR Swap Basis Could Pose 'Systemic Risk'", Helen Bartholomew, risk.net, 19 Sep 2022

This is a problem because there is effectively only one-way flow from end users to receive term-SOFR.

Why is the term-SOFR swap flow so one-sided? Regulation and Clearing

1. Corporate issuers that issued unswapped fixed-rate debt in the past could pay overnight SOFR against fixed on a new swap to create synthetic floating rate funding. However, the issuer would be unable to pay term-SOFR on the swap because ARRC recommends term-SOFR derivatives be "limited to end-user facing derivatives intended to hedge cash products that reference the SOFR Term Rate"[3].
2. Corporate issuers that issued swapped fixed-rate debt in the past will have their existing pay-3mL leg of the swap automatically turned into overnight SOFR after June 2023. Issuers that wish to turn their 3mL into term-SOFR would violate ARRC's recommendation (see above).
3. Investors who buy floating rate notes based on term-SOFR (such as CLOs) could pay term-SOFR and create a synthetic fixed-rate investment. As term-SOFR swaps cannot currently be cleared, investors would be required to execute a bilateral pay-term-SOFR swap, which may be more expensive due to uncleared margin rules, capital, credit and risk-weighted asset considerations. Some investor pay-term-SOFR bilateral swapping does occur, but anecdotally this counterflow offsets less than 5% of dealers' overnight-versus-term-SOFR basis risk.
4. Dealers with large risk positions in the overnight-versus-term-SOFR basis cannot offset the risk with another dealer which does not have a large position because ARRC recommends only "end-user facing derivative" trading of term-SOFR swaps[2].

The outcome is a notable lack of flow in which dealers can receive term-SOFR to pare down their overnight-versus-term-SOFR basis risk.

The Result

1. In theory, there should be no difference in value between 3m term-SOFR and overnight compounded SOFR for 3 months.
2. The one-way demand for dealers to pay term-SOFR has tilted the market to a mid-market basis swap spread of 3-4bps between term (3m or 6m) SOFR versus overnight SOFR. In other words, hedgers who wish to receive term-SOFR would receive 3-4bps (mid) less spread than receiving overnight SOFR.
3. Anecdotally, large dealers are each carrying net positions of $5-$10mm per basis point of this basis risk on their books.
4. Every incremental deal that requires dealers to pay term-SOFR would add to their risk position and dealers are likely to continue widening the term-vs-overnight basis spread to be compensated for the rising risk.

[3] "ARRC Best Practice Recommendations Related to Scope of Use of the Term Rate", Alternative Reference Rate Committee, New York Fed, 2021.

A Solution: Permit Term-SOFR Clearing and Liberalize Trading of Term-SOFR Swaps

Without a healthy two-way flow in term-SOFR, end users will likely pay an increasingly higher spread to manage their risk while dealers contend with rising term-versus-overnight basis risk on their books. This is not a healthy development for the derivative market. We can conceive of some developments to promote a greater balance in the term-SOFR market.

1. Permit term-SOFR derivatives to be cleared. This would allow investors to fix out term-SOFR investments and promote some opposing flows.
2. Allow term-SOFR derivative trading between dealers and financial entities. This would allow dealers to spread some of their risk to others who do not have as much exposure.
3. Liberalize the use of term-SOFR derivatives or apply the same limits to investors. ARRC should either permit issuers to elect and use term-SOFR as a valid floating rate instrument, or apply the same limitations on investors to restrict the use of term-SOFR in investments solely for risk reduction purposes.

Final Thoughts – Not an Auspicious Start for the New King

SOFR's teething problems are showing up even before it supplants LIBOR's role as the reference floating rate. Overnight SOFR has not been well-received by issuers or investors because they cannot budget cost or income ahead of the end of the accrual period. Investor preference for term-SOFR is forcing issuers to restructure existing debt or issue new debt based on term-SOFR, resulting in one-way demand on dealers to pay term-SOFR that is skewing the market.

ARRC recommended term-SOFR restrictions on issuers and dealers to promote the use of overnight SOFR, but the lack of uniformity of the restrictions (none on investors) resulted in an unbalanced market that saddles issuers with higher spread cost and restrictions[4]. Regulators and clearinghouses can and should do more to help resolve the problems that issuers and dealers face in the term-SOFR market or risk a wider derivative market imbalance.

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[4] An example of the term-SOFR restriction faced by issuers is ARRC's opposition to a November 2022 Toyota auto securitization that had a tranche indexed to term SOFR. (https://www.risk.net/our-take/7955497/arrcs-trivial-fight-over-term-sofr-use)

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