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Secured Overnight Financing Rate (SOFR)

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What Is the Secured Overnight Financing Rate (SOFR)?

The secured overnight financing rate, or SOFR, is an influential interest rate that banks use to price U.S. dollar-denominated [derivatives](#) and loans. The daily SOFR is based on transactions in the Treasury repurchase market, where investors offer banks overnight loans backed by their bond assets. The New York Federal Reserve began publishing the rate in April 2018 as part of an effort to replace [LIBOR](#), a long-standing benchmark rate used around the world.

KEY TAKEAWAYS

- The daily Secured Overnight Financing Rate is based on transactions in the Treasury repurchase market, where investors offer banks overnight loans backed by their bond assets.
- SOFR is seen as preferable to LIBOR because it's based on transaction data from the Treasury repo market, where there's extensive trading each day.



fixed-rate loans.

- While SOFR is becoming the benchmark rate for dollar-denominated derivatives and loans, other countries have sought their own alternative rates.

The Secured Overnight Financing Rate (SOFR) vs. LIBOR

Since its inception in the mid-1980s, the London interbank offered rate (LIBOR) has been the go-to interest rate to which investors and banks peg their credit agreements. Comprising five currencies, it's determined by calculating the average interest rate at which major banks around the world borrow from one another.

However, after the financial crisis of 2008, regulators grew wary of overreliance on that particular benchmark. For one, LIBOR is based largely on estimates from the global banks who are surveyed and not necessarily on actual transactions.

The downside of giving banks that latitude became apparent in 2012, when it was revealed that [more than a dozen financial institutions fudged their data](#) in order to reap bigger profits from LIBOR-based derivative products. Moreover, banking regulations after the financial crisis meant that there was less interbank borrowing happening. Some officials expressed concern that the limited volume of trading activity made the rate even less reliable.

FAST FACT



lending information after 2021.

History of the Secured Overnight Financing Rate (SOFR)

The British regulator that compiles LIBOR rates says it will no longer require banks to submit interbank lending information after 2021. That sent developed countries around the world scrambling to find an alternative reference rate that could eventually replace it.

In 2017 the Federal Reserve assembled the Alternative Reference Rate Committee, comprising several large banks, to select the alternative reference rate for the United States. The committee chose SOFR, an [overnight rate](#), as the new benchmark for dollar-denominated contracts.

Unlike LIBOR, there's extensive trading in the Treasury repo market—roughly 1,500 times that of interbank loans as of 2018—theoretically making it a more accurate indicator of borrowing costs. In addition, it's based on data from observable transactions rather than on estimated borrowing rates, as is sometimes the case with LIBOR.

Factors in the Transition to SOFR

For now LIBOR and SOFR will coexist. However, it's expected that the latter will supplant LIBOR over the next few years as the dominant benchmark for dollar-denominated derivatives and credit products.

Transitioning to a new benchmark rate involves considerable difficulty, as there were roughly \$200 trillion worth of LIBOR-based contracts outstanding in 2018. Some of these



Repricing contracts is complex, because the two interest rates have several important differences. For example, LIBOR represents unsecured loans, while SOFR, representing loans backed by Treasury bonds, is a virtually risk-free rate.

In addition, LIBOR actually has 35 different rates, covering five currencies and seven different maturities. As of now, SOFR only publishes one rate based exclusively on overnight loans.

Other countries have sought their own alternatives to LIBOR. The United Kingdom chose SONIA, an overnight lending rate, as its benchmark for sterling-based contracts going forward. The European Central Bank opted to use EONIA, which is based on unsecured overnight loans, while Japan will be using its own rate, which is called TONAR.

Understanding SOFR's Role in the Banking System

Benchmark rates such as SOFR are [essential in the trading of derivatives](#)—particularly [interest-rate swaps](#), which corporations and other parties use to manage interest-rate risk and to speculate on changes in borrowing costs.

Interest-rate swaps are agreements in which the parties exchange fixed-rate interest payments for floating-rate interest payments. In a “vanilla” swap, one party agrees to pay a fixed interest rate, and in exchange the receiving party agrees to pay a floating interest rate based on SOFR (the rate may be higher or lower than SOFR, based on the party’s credit rating and interest-rate conditions).



payments to the counter-party remains the same. The inverse occurs when rates go down.

While the transition to SOFR will have the greatest impact on the derivatives market, the rate will also play an important role in consumer credit products—including some [adjustable-rate mortgages](#) and private student loans—as well as debt instruments such as [commercial paper](#). In the case of an adjustable-rate mortgage based on SOFR, the movement of the benchmark rate determines how much borrowers will pay once the fixed-interest period of their loan ends. If SOFR is higher when the loan “resets,” homeowners will be paying a higher rate as well.

Related Terms

Singapore Interbank Offered Rate (SIBOR)

The Singapore Interbank Offered Rate (SIBOR) is the benchmark interest rate for lending between banks in markets within the Asian time zones. [more](#)

Hong Kong Interbank Offered Rate (HIBOR)

The Hong Kong Interbank Offered Rate (HIBOR) is a Hong Kong dollar-based interest rate benchmark for lending between banks in the Hong Kong market. [more](#)

LIBOR

LIBOR is a benchmark interest rate at which major global lend to one another in the international interbank market for short-term loans. [more](#)

The LIBOR Scandal

The LIBOR scandal, which came to light in 2012, involved a scheme by bankers to manipulate the London Interbank Offered Rate (LIBOR) for profit. [more](#)

How the Bank Bill Swap Bid Rate Works



Johannesburg Interbank Average Rate (JIBAR)

The Johannesburg Interbank Average Rate (JIBAR) is the money market rate that is used in South Africa. The rate comes in one-month, three-month, six-month, and 12-month discount terms. [more](#)

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