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MARKETS

Repo-Market Tumult Raises Concerns About New Benchmark Rate

Volatility in funding markets sparks a jump in the rate that the Fed has proposed to replace Libor

By Daniel Kruger and Vipal Monga

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The tumult in the market for short-term cash loans highlights some analysts' concerns about the Federal Reserve's proposed replacement for the troubled London interbank offered rate.

The secured overnight financing rate, known as SOFR, rose to a record 5.25% last week, according to the Federal Reserve Bank of New York, pulled higher by a jump in borrowing rates for overnight repurchase agreements, or repos.

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SOFR's price is based on repo rates, so the spike in that market last Tuesday caused the new benchmark for variable-rate securities to jump almost 3 percentage points to its highest level on record. It fell back to 1.86% on Friday.

The move was closely watched because a group of bankers, investors and regulators overseen by the New York Fed has designated SOFR as the preferred replacement for the longtime variable-rate benchmark known as Libor. That rate, which underpins trillions of dollars of loans including home mortgages and corporate loans, fell out of favor after a manipulation scandal.

Libor is slated for replacement in 2021 and finding a substitute is a key challenge for banks, companies and investors. Each wants a reference rate that reflects the risks from short-term lending and is supported by a liquid market that behaves in a predictable manner. Properly setting the rates on business and consumer loans can determine whether such loans are affordable for borrowers and profitable for lenders.

The swings in SOFR make it appear unstable, undermining "the confidence the market has in

The Federal Reserve Bank of New York has designated the secured overnight financing rate, known as SOFR, as the preferred replacement for Libor. PHOTO: CEM OZDEL/ANADOLU AGENCY/GETTY IMAGES

using it as a fallback to Libor," said Mark Cabana, an interest-rate strategist at Bank of America. The rise of repo rates well above the Fed's target for overnight rates for loans between banks is a sign that "the Fed lost control of funding markets," he said.

The increased volatility also raised concerns about whether the transition from Libor can be completed on schedule.

"It's very problematic," said John Spaid, executive vice president for finance at National Health Investors, a real-estate investment trust that focuses on assisted living facilities and hospitals.

Participants in the working group of banks, investors and regulators convened by the New York Fed to manage the transition away from Libor—known as the Alternative Reference Rate Committee, or ARRC—said the one-day spike in SOFR, while unusual, would barely register for users of the rate. SOFR is usually averaged out over 90 days when used in transactions, which smooths out short-term volatility.

Using the 90 day-average, SOFR moved only 0.02 percentage point after accounting for Tuesday's jump, said Brian Grabenstein, who leads the Libor transition efforts for ARRC member bank Wells Fargo. The three-month Libor rate, meanwhile, rose 0.04 percentage point.

Although that limited the impact of Tuesday's spike, the fact that SOFR swung so widely could give some borrowers and lenders pause as they prepare to use it, said Anne Beaumont, a lawyer who represents investment and asset management firms at New York-based Friedman Kaplan Seiler & Adelman LLP.

"It certainly raises the question in people's minds as to whether the rate could be unstable, not for market reasons, but for other reasons, and that is troubling," she said.

Others said that the wobbles last week in the repo market don't diminish the likelihood that SOFR becomes the U.S.'s chosen alternative to Libor.

"The ARRC was aware that repo is volatile" when it tapped SOFR as its preferred replacement, said Eric Donovan, who trades interest-rate derivatives at INTL FCStone.

Kristi Leo, president of the Structured Finance Association, said investors represented by the trade group are showing a "modest" level of concern about SOFR's volatility. Many expected rates to jump at quarter ends, when demands on cash are high, but the recent outsize moves in repo rates are unusual, and investors are "still evaluating" the new benchmark.

"They have not found a better solution," she said.

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