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MARKETS

New Benchmark Rate, Gunning to Replace Libor, Gains Traction

Recent volatility fuels increase in trading of contracts linked to rate

By Daniel Kruger and Telis Demos

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Trading in forward contracts using the benchmark rate expected to replace Libor surged to a record this month.

Interest-rate swaps are contracts that allow users to hedge or bet on the cost of future interest payments. The secured overnight financing rate, or SOFR, is now the leading alternative used by the contracts, as opposed to the discredited London interbank offered rate, known as Libor. SOFR was introduced by the Federal Reserve of New York in April 2018.

About $13.6 billion in SOFR-linked swaps changed hands this month, data through Friday shows. That is almost twice the previous high in January and more than 40% of the SOFR swap trades that have taken place since July.

The rise in trades indicates that market participants may be concerned about big moves in the near future. That is partly because of the quarter-end volatility that led to a spike in SOFR in December, analysts say. Investors may be using SOFR swaps to hedge against a repeat of the volatility that hit the market at the end of the fourth quarter.

“The market is quite nervous about quarter-end after what we saw at year-end,” said Gennadiy Goldberg, an interest-rate strategist at TD Securities.

On Dec. 31, SOFR jumped from 2.46% to 3.00%, the highest level at the time since the Fed began publishing the benchmark.

SOFR is based on the cost to borrow cash overnight in the market for repurchase agreements, or repos, where lenders such as money-market funds make short-term loans to bond brokers, often using government debt as collateral. That underlying rate, known as the general collateral financing repo rate, which reflects the cost to exchange cash for collateral assets such as government bonds, is typically volatile near the end of months, quarters and years, when banks generally shrink their balance sheets.

The GCF repo rate topped out above 6% in intraday trading on Dec. 31 before settling at an all-time high of 5.149%.

On Thursday, the SOFR rate was 2.43%, Fed data shows, while the GCF repo rate was 2.478%, according to the Depository Trust & Clearing Corp.

It is unclear which direction traders are betting the market will go. It is also unclear whether the users of these swaps are debt issuers who are worried their SOFR-linked interest payments could rise or hedge funds speculating on the movement of rates.

The volume in swaps relative to the amount of SOFR-backed debt outstanding suggests that the swaps were put on by hedge funds, said Roy Choudhury, the Americas capital-markets advisory leader at Ernst & Young LLP. According to analysts, hedge funds could be using the swaps to make a low-cost bet on a sudden jump in the overnight cost to hold cash.

Commuters wait for a train in New York. The New York Metropolitan Transportation Authority issued the first floating-rate municipal debt linked to SOFR in September. **PHOTO:** CHRISTOPHER LEE/BLOOMBERG NEWS

Libor still underpins as much as $350 trillion of financial transactions globally. For many years, the rate was closely watched as a benchmark for lending and a measure of stress in the banking system. But over the last decade, it was discredited after evidence emerged that bank traders were manipulating it to make trading profits.

Robust swaps trading is a sign SOFR is gaining traction in replacing Libor, Mr. Choudhury said. In the long run, companies hedging their debt are expected to account for a larger share of activity linked to SOFR, he said.

Bond issuers that have sold debt with interest rates linked to SOFR include Fannie Mae, MetLife Inc. and the New York Metropolitan Transportation Authority.

"It's a very positive thing that market participants are using SOFR derivatives as another tool to manage risk," said Thomas Pluta, JPMorgan Chase & Co.'s global co-head of rates trading. "[It] indicates the continued development of the market."

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