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MARKETS

Companies Slow to Adopt Libor Replacement

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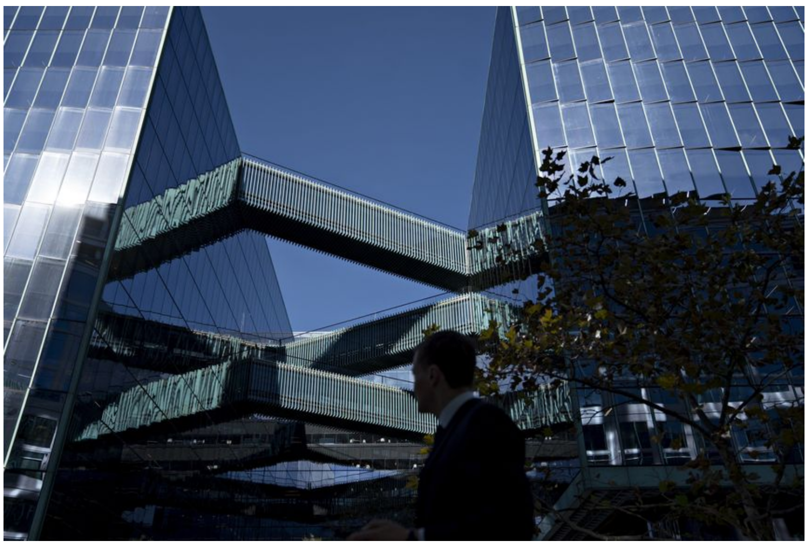

Fannie Mae headquarters **PHOTO**: ANDREW HARRER/BLOOMBERG NEWS

By Daniel Kruger and Telis Demos

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Companies are dawdling in their adoption of the Federal Reserve's preferred replacement for the interest-rate benchmark underpinning trillions of dollars in financial contracts.

Borrowers led by Fannie Mae, the federal mortgage finance agency, have sold $105 billion of floating-rate securities linked to SOFR, the secured overnight financing rate, since it made its debut almost a year ago, according to CME Group Inc. In that period, according to Wells Fargo & Co., companies have sold more than $900 billion of debt tied to the London interbank offered rate, the old benchmark for variable-rate debt.

Libor, used to underpin everything from home mortgages to corporate loans, was slated for replacement in 2021 after a manipulation scandal and finding a replacement 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.

Regulators and banks, including Bank of America Corp. , Citigroup Inc. and JPMorgan Chase & Co., in 2014 formed a working group—known as the Alternative Reference Rates Committee—to help create SOFR. The group is ahead of schedule in meeting its key goals, said Brian Grabenstein, who leads Wells Fargo's Libor transition efforts and is a member of the committee.

While the group says adoption is happening at a rapid pace, "that's not really the sense I get when speaking to our clients," said Mark Cabana, head of short-term interest-rate strategy research at Bank of America Merrill Lynch.

Companies are in "a state of paralysis" as they await the creation of longer-term SOFR rates, he said.

Fannie Mae has sold $15.5 billion of SOFR senior unsecured debt since last July and no Libor debt. But it continued to use Libor when selling $10 billion of mortgage and risk-transfer securities.

"We think it's important for not just Fannie Mae, but for other market participants, to prepare for a world without Libor," a representative for the mortgage company said in response to emailed questions. "Each product is evaluated independently given that they trade in different markets and have different investor bases."

In October, Toyota Motor Corp. raised $500 million in the first nonbank SOFR commercial paper offering. While it continues to sell Libor-linked debt, "we are aware that Libor may cease to be quoted after 2021," said Nicholas Ro, manager of sales and trading for Toyota Financial Services. "That's why we took steps to use SOFR starting in 2018 to begin our transition process."

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SOFR is seen as more reliable than Libor because it is derived from the rate to borrow cash overnight using U.S. government securities as collateral. These trades are known as overnight repurchase agreements, or repos. Libor is set by a group of banks in London that provide estimates of the rate at which they could lend to other banks over various periods. Those estimates take into account the risk the borrowers won't repay the debt.

The repo market is also vastly larger than the market for short-term bank loans, which has shrunk since the financial crisis.

The Fed's working group is also reaching out to designers of accounting and trading systems about speeding development of products that can function with the new rate. Many investors and companies can't buy or sell debt linked to SOFR because their accounting and trading systems aren't properly configured for it, said Venetia Woo, principal director of North American regulatory strategy at Accenture.

"The reality is, people want to trade and people want to hedge," Ms. Woo said. "Physically their infrastructure is not ready for it."

The Fed last month released a paper written by two central bank economists describing a method to calculate longer-term SOFR rates using prices from futures contracts. Analysts have said this kind of term structure could make selling floating-rate debt linked to SOFR more attractive for companies.

Fed officials are seeking more trading data on SOFR-linked futures and interest-rate swaps because they are reluctant to push new structures to market without ensuring they work, analysts said.

However, collecting repo trading data isn't a simple matter, especially for the smaller, more diffuse market of repo trades that are longer than overnight, so-called term trades.

Many players in the repo market—such as hedge funds and asset managers—aren't regulated by the Fed. Officials have met with vendors in the repo market to discuss data collection, but it isn't clear how quickly that effort might come together.

"Market participants are not uniformly comfortable in sharing those data with the broader market," said Glenn Havlicek, a former banker who is now chief executive of GLMX, a technology company that provides tools to repo trading firms.

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