SOFR and credit spread

Not as simple as it seems

The adoption of the secured overnight financing rate (SOFR) is forcing firms to think about credit spreads and how to apply them to new and old transactions. While some firms may default to existing processes to determine credit spread, the structural and behavioral differences between Libor and SOFR are compelling others to rethink the traditional approach. Any reformulation of a firm's credit spread methodology will also require a reassessment of pricing strategies and conduct risk implications, in addition to operational impacts.

Historically, Libor has adjusted—albeit artificially through expert judgement—either up or down depending on perceptions related to the economy, perceived stress, liquidity and market demand. The fact Libor is an unsecured rate with an implied credit component allowed its contributors to factor in adjustments warranted by prevailing conditions. Banks could take solace in knowing that, if their cost of funds rose in times of stress, a compensating rise in Libor lending rates would also occur, thereby protecting interest margin.

Replacing Libor with SOFR could jeopardize this long-standing paradigm. Very simply, SOFR is an average rate—calculated by the US Federal Reserve—built on secured repo transactions. Because the underlying transactions used to derive SOFR are collateralized, SOFR tends to decline in times of market stress and dislocation (flight to quality or safety), which contrasts with how Libor responds in similar market conditions. Recent stressed market conditions have only served to emphasize the potential for divergence between the two benchmarks, so it is clear that the underlying difference between the rates means there will need to be careful thought regarding whether to include a basis adjustment for this difference and, if so, how?

This flight-to-quality phenomenon coupled with the market-driven nature of SOFR also introduces the possibility that SOFR rates may go below zero—a circumstance that has never happened with USD Libor. Although the published rate has yet to register a negative rate, there have been several underlying secured repo transactions, the general collateral type, which have yielded a negative return. The potential for this outcome has banks scrambling to understand where and how a floor can be implemented or if some other dynamic compensating modification can be easily made.

Given the diverging behavior between rates, many banks are exploring the spread component to best mitigate the 'rate differences' risk. Some banks have started looking at alternatives to SOFR, preferring to explore a rate much closer in construct to Libor to solve the credit spread differences. Several rates are being considered because they have an implied credit component that, much like Libor, will be affected by general bank credit quality. While these alternatives seem to have some interesting features, they are not without issues. Given they are not identical to Libor, some adjustments will need to be made to the underlying rate; the underlying volume will need to be compliant with International Organization of Securities Commissions principles and there is always the question of developing a benchmark-quality term structure.

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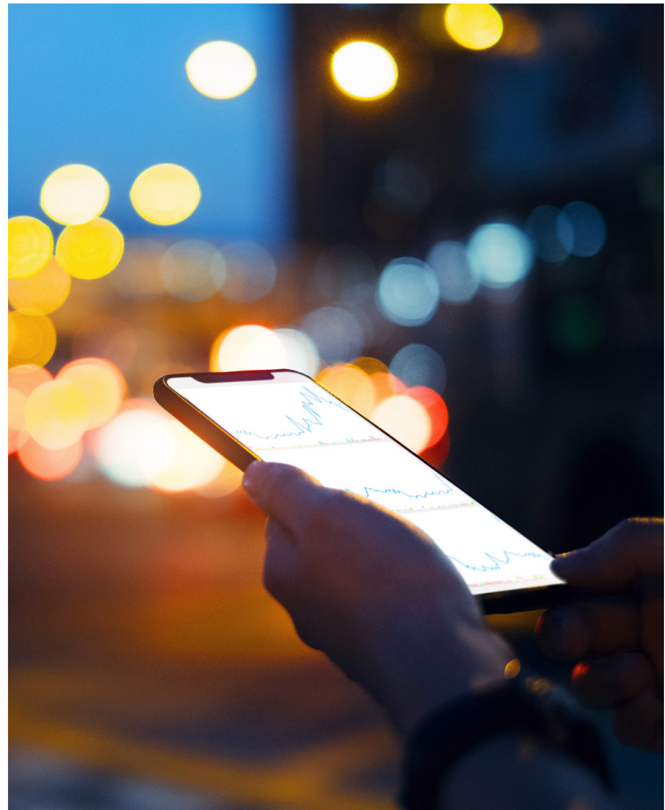
Other benchmarks might be plausible, but not probable. Banks will need to consider other alternatives to compensate for differences between Libor and SOFR. The Alternative Reference Rates Committee (ARRC) working group and industry bodies have explored the differences between the two rates deciding that, at least for legacy trades, an adjustment will be required to recognize the credit component in Libor. The ARRC has published a spread adjustment methodology based on a five-year historical median between Libor and compounded SOFR. The static adjustment would be applied to all legacy transactions in an attempt to offset the structural difference between the two rates. While this addresses a specific concern, it does not help with the behavioral issues that banks are grappling with. The same can be said for any static spread applied to SOFR, whether for legacy transactions or new transactions.

Banks are also now trying to explore other ideas such as premium spread add-ons, dynamic spreads and fee levies. All have some merit but do not perfectly address every concern. The drive to create a robust market-driven benchmark is not without growing pains, the market will adjust as liquidity grows and the market matures.



Contact us

Chris Dias
Principal
Global LIBOR Solution Co-Lead
T: 212-954-8625
E: cjdias@kpmg.com

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