What is SOFR? LIBOR?

We have all been hearing the term "SOFR" and "LIBOR" batted around recently but do we understand exactly what they are? Here's my attempt to break it down. First, SOFR stands for "Secured Overnight Financing Rate" and LIBOR stands for "London Interbank Offered Rate." For a long time, LIBOR was the main go-to entity (benchmark*) to set interest rates on commercial and consumer loans. However, during the 2008 financial crisis, they messed up big time when they manipulated rates. Sam Weller, Senior Vice President and Director of Capital Markets at Bryn Mawr Trust, explains in it a nutshell: "The financial crisis of 2008 and 2009 revealed some of the technical shortcomings of LIBOR. Various LIBOR rate fixing scandals have made it clear to banking regulators that a more robust, risk-free reference is needed as a permanent replacement for LIBOR."

Enter SOFR. And why is it better?

SOFR is a stable interest-rate benchmark that financial institutions use to price loans for businesses and consumers. SOFR's "overnight financing" is based on the rates that large financial institutions pay each other for overnight loans. SOFR is regulated by the Fed Board and Financial Stability Oversight Council (FSOC). Unlike LIBOR, who based rates on what financial institutions "said" they would offer each other for short-term loan, SOFR uses transparent methods to determine a common benchmark rates that are based on observed, cleared transactions in the marketplace. In other words, SOFR is based on completed financial transactions while LIBOR relied on quotes from reporting banks that weren't necessarily from actual financial transactions.

Additionally, LIBOR was unsecured (loans it was based on were not collateralized) so it included a credit risk premium. SOFR is a secured rate collateralized by U.S. Treasuries so there's no credit risk premium. Note that there are other LIBOR alternatives used in the U.S. or overseas such as Sterling Overnight Index Average (SONIA) in the UK, Federal Funds Overnight Index, Ameribor., and the U.S. prime rate.

How Does SOFR Work?

Large financial institutions lend money to each other using Treasury "repos" (bond repurchase agreements) which allow banks to make overnight loans, using U.S. Treasuries as collateral. SOFR comprises the weighted averages of the rates charged in these repo transactions. This rate is published every morning by the New York Federal Reserve based on the rate SOFR calculated the previous business day.

What Does SOFR Mean for You?

Probably nothing except confidence in the knowledge that your interest rates are based on much sounder principles and collateral then they were before. And that is something!

Lastly . . . .

The final transition from LIBOR to SOFR references the date Goldilocks keeps telling us about —June 30, 2023.

*a standard against which something is compared and used to measure performance of securities, mutual funds, exchange-traded funds, portfolios, cryptocurrencies, etc.

Please check out the articles below to learn more.

https://www.forbes.com/advisor/investing/secured-overnight-financing-rate-sofr/

https://www.investopedia.com/terms/b/benchmark.asp

https://www.srsacquiom.com/resources/sofr-vs-libor

https://www.wallstreetprep.com/knowledge/sofr-secured-overnight-funding-rate/