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A Little Around the Sides

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News reached us last week of the passing of Anthony Mancinelli. According to Guinness World Records, Mr. Mancinelli at 108 was the oldest working barber.

Cutting hair since Warren Harding occupied the White House, the barber from Naples emigrated to the US in 1919 and opened his first shop in Newburgh, NY. He kept snipping and scissoring for 96 years until weeks before his death.

When asked for his secret to longevity, Mr. Mancinelli replied, "I eat thin spaghetti."

We ourselves have not frequented hair-cutting establishments since the Reagan Administration. Nevertheless, we know a close shave when we see one.

Take the process of replacing LIBOR. The current inter-bank reference rate is scheduled to disappear by December 31, 2021. The leading candidate to take over as a leveraged loan benchmark is the Secured Overnight Financing Rate, or SOFR.

SOFR carries with it several advantages over LIBOR. First, it represents a much deeper market – more than $1 trillion of daily trading, according to the LSTA – than the prior base rate. It is also collateralized by Treasury securities trades, rather than unsecured inter-bank loans.

Another important differentiator is that SOFR – unlike LIBOR, which is based on bank bidding – is established via real repo rates, so the likelihood of manipulation is lower.

Our friend at the LSTA, Meredith Coffey, an expert on such matters, was quoted recently in Creditflux. "SOFR represents actual transactions," she said, "whereas LIBOR does not. It's the reason we are going to SOFR."

But that transition isn't nick-free. SOFR is a daily rate, carrying with it expectations of more volatility than LIBOR. That was demonstrated in spades last month when (*Chart of the Week*) repo rates spiked sending SOFR to a record high 5.25%.

The underlying factors are complicated, but when banks found themselves short of cash approaching quarter-end, the upswing in demand sent the short-term repo market into a tizzy. The Fed stepped in with supplemental liquidity, but the episode left analysts alarmed. What would have happened to loan costs if SOFR had been operational?

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The good news, according to rate experts, is that the new benchmark would be calculated as a 90-day average to smooth over such blips. Adjusted for that, SOFR was up only 0.02%, while LIBOR increased twice as much.

In a WSJ article, Kristi Leo of the Structured Finance Association, a trade group, said there was some worry about SOFR's volatility. Investors are "still evaluating" the proposed benchmark.

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