AFX Research Note
June 22, 2022

A Cautionary Tale about Basis Risk: Liquidity and Credit Spreads Leading into the 75-bps Tightening on June 15th, 2022

Leading into and following June 15th's FOMC meeting, the American Financial Exchange's Overnight Unsecured AMERIBOR® Loan Market has experienced a nearly threefold surge in volume in week-over-week trading, touching levels above $2 billion in daily volume after a period of relatively light demand. The primary driver of this rapid increase in demand was based on an anticipated rate increase by the Fed. This resulted in an early upwards repricing in other sources of liquidity such as SiFis and the Federal Home Loan Banks (FHLBs). We had numerous members come onto the platform - from across the country, particularly out of the east and west coasts – with single trades reaching $400 million and de minimis impact on price. This liquidity is facilitated by our large web of counterparty credit lines – about 1,800 lines approaching $80 billion in new credit lines since inception.

These members indicated that AFX's abundant funding availability alleviated some of the constraints created by the sudden shift in pricing. We've seen this trend before during previous hiking cycles. SiFis and the FHLBs will typically begin inching their short-term advance rates up in anticipation of a rate hike over the course of a couple weeks, with significant movements 1-3 days before the hike occurs.

As the Fed is currently moving at the most aggressive pace they have in decades, we expect to see this pattern persist in future hikes. AFX reliably sees an increase in trading volume during times of market uncertainty with no price distortions. Examples include the final days leading into a rate hike, the repo and subsequent SOFR rate spikes in September of 2019, and the onset of the Coronavirus Pandemic in March of 2020, where our volumes eclipsed $3 billion in daily trading.

During periods of market volatility, the overnight AMERIBOR® market serves as not only a valuable source of funding for banks of all sizes but also provides additional utility as the source of a stable and predictable overnight benchmark even in turbulent conditions. The overnight AMERIBOR® index saw a slight rise over the past three days, as market conditions tightened in advance the outcome of the Federal Reserve's FOMC meeting being released. This behavior was also seen in the FHLB advance rates over the past few days, serving as further evidence that this was the true market conditions for overnight funding.

The overall percentage spread between risk-free overnight SOFR and credit-sensitive overnight AMERIBOR® increased from 22.0% to 35.4% over a three-day span leading into this most recent FOMC meeting, from Friday, June 10th to Tuesday, June 14th.

In contrast to overnight AMERIBOR® and the FHLB advance rates, overnight SOFR fell 8.0% leading up to June 15th's FOMC meeting, falling from 75.0 basis points on Friday, June 10th to 69.0 basis points as of Tuesday, June 14th. Over the same span, overnight AMERIBOR® rose 2.1% to 93.4 basis points from 91.5 basis points.

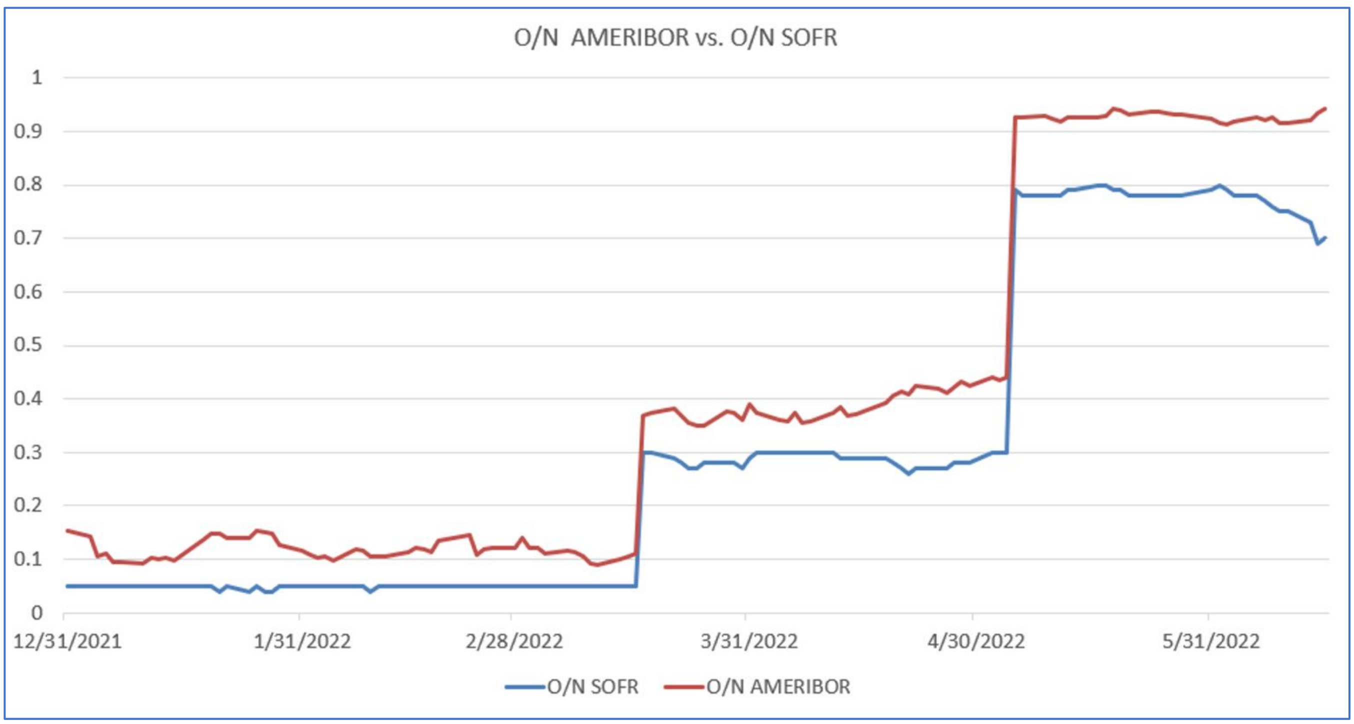
FOMC Meeting Date	6/10/22 Overnight AMERIBOR® Rate	6/10/22 Overnight SOFR Rate	6/10/22 Credit Spread (basis points)	6/10/22 Credit Spread (percentage)	6/14/22 Overnight AMERIBOR® Rate	6/14/22 Overnight SOFR Rate	6/14/22 Credit Spread (basis points)	6/14/22 Credit Spread (percentage)
6/15/2022	0.91496	0.75	16.4	22.0%	0.93413	0.69	24.4	35.4%

This drop in overnight SOFR can be attributed to overnight SOFR being derived from the repo market, which has seen an influx of liquidity during this on-going period of heightened macro volatility as investors dump risk assets for cash and deposit into money-market accounts.

AFX's overnight lending market is not only a nationwide funding source for financial institutions of all sizes, but serves as the underpinnings of a stable, transparent and predictable overnight benchmark available to serve any and all financial needs.

Freedom of choice in LIBOR replacement benchmark was recently codified into law in Section 106 of the U.S. Omnibus Appropriations Bill, which states *"the bank, in any non-IBOR loan*[1] *made before, on, or after the date of enactment of this Act,* ***may use any benchmark, including a benchmark that is not SOFR, that the bank determines to be appropriate for the funding model of the bank; the needs of the customers of the bank; and the products, risk profile, risk management capabilities, and operational capabilities of the bank****; provided, however, that the use of any benchmark shall remain subject to the terms of the non-IBOR loan, and applicable law****; and no Federal supervisory agency may take any covered action against the bank solely because that benchmark is not SOFR****."*

LIBOR is dead and we now have choice in fundamentally different interest rate benchmarks: one risk-free and two credit-sensitive.



This recent pattern raises a cautionary tale for risk managers. Basis-risk increased by nearly 50% during this three-day period. If the terminal interest rate is 4%, this has great implications for bank profitability and capital needs. If we add an exogenous shock and credit spreads widen to reflect that, there is even more bank and systemic risk. Once again, choice in benchmarks can mitigate this risk. Furthermore, banks and corporations that lend or borrow based on SOFR may want or need to execute basis swaps. There may be limited capacity in that market, increasing overall basis risk.

[1] Non-IBOR loans simply refer to any loan referencing any benchmark that is unassociated with LIBOR.

Future research will be published on the basis risk for overnight and term risk.