ARRC Releases a User’s Guide to SOFR

ARRC Encourages the Transition Away from LIBOR to SOFR

The Alternative Reference Rates Committee (ARRC) today released a white paper to help explain how market participants can use its recommended alternative to U.S. dollar LIBOR, the Secured Overnight Financing Rate (SOFR), in cash products. This paper builds on the ARRC’s work developing the Paced Transition Plan, which outlines the steps for an effective shift to SOFR.

“We have only a little over two and a half years until LIBOR could become unusable. It’s crucial for the safety of the financial system, and for the many firms using LIBOR, that they not wait to begin a transition. By releasing this white paper, the ARRC shows how market participants can use SOFR and transition now,” said Tom Wipf chair of the ARRC and Vice Chairman of Institutional Securities at Morgan Stanley. “We encourage market participants to begin writing contracts using SOFR instead of U.S. dollar LIBOR.”

The paper makes several points:

- SOFR is the ARRC’s preferred alternative to U.S. dollar LIBOR. It has number of characteristics that LIBOR and other similar rates do not:
  - It is produced by the New York Fed for the public good;
  - It is derived from an active and well-defined market with sufficient depth to make it extraordinarily difficult to ever manipulate or influence;
  - It is produced in a transparent, direct manner and is based on observable transactions rather than being dependent on estimates, like LIBOR, or derived through models; and,
  - It is derived from a market that was able to weather the global financial crisis and that the ARRC credibly believes will remain active enough in order that it can reliably be produced in a wide range of market conditions.

- Financial products either explicitly or implicitly use some kind of average of SOFR, not a single day’s reading of the rate, in determining the floating-rate payments that are to be paid or received. An average of SOFR will accurately reflect movements in interest rates over a given period and smooth out any idiosyncratic, day-to-day fluctuations in overnight market rates.

- Issuers and lenders will face a technical choice between using a simple or a compound average of SOFR. In the short-term, using simple interest conventions may be easier since many systems are already set up to accommodate it. However, compounded
interest would more accurately reflect the time value of money and allow for more accurate hedging.

- Users need to determine the period of time over which the daily SOFRs are averaged. An *in advance* structure would reference an average of SOFR observed before the current interest period begins, while an *in arrears* structure would reference an average of SOFR over the current interest period.

- An average of SOFR *in arrears* will reflect what *actually happens* to interest rates over the period and the paper discusses a number of conventions designed to allow for a longer notice of payment within this *in arrears* framework. The note also discusses conventions for *in advance* payment structures and hybrid models that can reduce the basis relative to *in arrears*.

The paper also explains the interaction between SOFR and the type of forward-looking term rates that the ARRC has set a goal of seeing produced once SOFR derivative markets develop sufficient depth. While these term rates can be a useful tool for some users and an integral part of the new ecosystem, hedging these rates will tend to entail more transaction costs than using SOFR directly and their use must be consistent with the functioning of the overall financial system. For this reason, the ARRC sees some specific productive uses for a forward-looking SOFR term rate, in particular as a fallback for legacy cash products referencing U.S. dollar LIBOR and in loans where the borrowers otherwise have difficulty adapting to the new environment, and believes that those who are able to use SOFR should not wait for the term rates in order to transition.

**About the ARRC**
The ARRC is a group of private-market participants convened by the Federal Reserve Board and Federal Reserve Bank of New York in cooperation with the Consumer Financial Protection Bureau, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Office of Financial Research, the Office of the Comptroller of the Currency, the Commodity Futures Trading Commission, the Securities and Exchange Commission and the U.S. Treasury Department. It was initially convened in 2014 to identify risk-free alternative reference rates for U.S. dollar LIBOR, identify best practices for contract robustness, and create an implementation plan with metrics of success and a timeline to support an orderly adoption. The ARRC accomplished its first set of objectives and identified SOFR as the rate that represents best practice for use in certain new U.S. dollar derivatives and other financial contracts. It also published its **Paced Transition Plan**, with specific steps and timelines designed to encourage adoption of SOFR. The ARRC was reconstituted in 2018 with an expanded membership to help to ensure the successful implementation of the **Paced Transition Plan**, address the increased risk that LIBOR may not exist beyond 2021, and serve as a forum to coordinate and track planning across cash and derivatives products and market participants currently using U.S. dollar LIBOR.

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