Frequently Asked Questions on Best Practice Recommendations Related to Scope of Use of the Term Rate

Prior to the ARRC’s [formal recommendation](#) of the CME Group’s forward-looking SOFR Term Rates (“the SOFR Term Rate”), the ARRC laid out its [best practice recommendations](#) on the scope of use of the SOFR Term Rate in contracts. This document seeks to answer the most frequently asked questions regarding the best practices.

1. Why did the ARRC publish recommendations related to the scope of use of the SOFR Term Rate?

The ARRC published [principles](#) related to scope of use before finalizing a recommended scope of use. One particular principle articulated why limits to scope of use were important as follows:

“The rate should...have a limited scope of use, to avoid (i) use that is not in proportion to the depth and transactions in the underlying derivatives market or (ii) use that materially detracts from volumes in the underlying SOFR-linked derivatives transactions that are relied upon to construct a term rate, making the term rate itself unstable over time.”

The ARRC’s [recommendations related to scope of use](#) of the SOFR Term rate are intended to promote that objective.

Consistent with that objective, the ARRC continues to recommend SOFR for all products, and as a general principle, recommends that market participants use overnight SOFR and SOFR averages given their robustness, particularly in markets where we have seen that there can be successful adoption of these rates. But the ARRC also recognizes that there could be certain conditions where adapting to an overnight rate could be more difficult and it thus developed its recommendations for the use of the SOFR Term Rate.

In its recommended best practices, the ARRC highlighted particular areas where use of the SOFR Term Rate will be helpful to support a smooth transition away from USD LIBOR, taking into account feedback from a broad set of stakeholders. The ARRC noted that SOFR Term Rate will be especially helpful for the business loans market—particularly multi-lender facilities, middle market loans, and trade finance loans—where transitioning from LIBOR to an overnight rate has been difficult.

In addition, the ARRC recommended that “any use of SOFR Term Rate derivatives be limited to end-user facing derivatives intended to hedge cash products that reference the SOFR Term Rate. This limitation is intended to avoid use that is not in proportion to, or materially detracts from, the depth of transactions in the underlying derivatives markets that are essential to the construction of the SOFR Term Rate over time.”

2. The ARRC stated that it supported the use of SOFR Term Rate derivatives for end-user facing derivatives intended to hedge cash products that reference the SOFR Term Rate. For these purposes, what constitutes an end-user facing derivative hedging a SOFR Term Rate cash product?
The ARRC recognizes that some end users may wish to hedge cash products that reference the SOFR Term Rate with a SOFR Term Rate derivative to simplify their operations and supports such use of SOFR Term Rate derivatives.

The ARRC, however, does not support the use of the SOFR Term Rate for the vast majority of the derivatives markets. The ARRC does not recommend the trading of SOFR Term Rate derivatives in the interdealer market because such activity could undermine trading activity in the underlying overnight SOFR derivatives that are needed to construct the SOFR term rate itself and could, thereby, compromise the robustness of the rate and its corresponding utility to market participants. In general, the ARRC understands that dealers offering SOFR Term Rate derivatives to end users can effectively warehouse the risk associated with such offerings, including through the use of overnight SOFR derivatives. The ARRC understands that most dealers regularly manage basis risks and the ARRC believes that the basis risk between the use of derivatives based on overnight SOFR and the SOFR Term Rate will typically be small and well within their capacity to manage effectively.

- For the purposes of the ARRC’s derivatives recommendations, the ARRC considers an end user to be a direct party or guarantor to a new SOFR Term Rate business loan or securitization linked to SOFR Term Rate assets, or to a legacy LIBOR product that has converted to the SOFR Term Rate through contractual fallback language or legislation.

- Under the ARRC’s recommended use of SOFR Term Rate derivatives, an end user (for example, either a lender or borrower who have entered in to a SOFR Term Rate business loan), could enter in to a SOFR Term Rate swap, cap, swaption, or similar derivatives contract to hedge that SOFR Term Rate cash product exposure, or a portfolio of such exposures, and could adjust or unwind that hedge over time, including through novations. A dealer counterparty to these hedges would not be considered an end user under these recommendations, and the ARRC does not recommend that the dealer seek to hedge its own resulting SOFR Term Rate exposure with an additional SOFR Term Rate derivative. However, the dealer counterparty to these hedges could hedge its own exposure using derivatives linked to forms of overnight SOFR, consistent with the ARRC’s recommendation that overnight SOFR and SOFR averages be used in cases where a party wishes to hedge in an efficient and transparent manner.

- The ARRC recognizes that some lending institutions are not structured to make markets or warehouse the risk of offering derivatives products to end users but may wish to enter in to a SOFR Term Rate swap, cap, swaption, or similar derivative as part of their services to help a borrower hedge a SOFR Term Rate business loan. In this instance, provided that the institution does not make two-way prices in interest rate derivatives and is not a market maker in the interdealer market for such derivatives in the regular course of its business, the ARRC considers that the use of offsetting derivatives matching the derivatives exposure that the institution has

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1 The ARRC recognizes that bank Treasury or lending desks may sometimes rely on an affiliated dealer to execute their derivatives hedges with third-party swaps dealers in order to hedge SOFR Term Rate cash product that the Treasury or lending desk is a direct party to. For clarity, the ARRC views such arrangements as part of the bank’s hedging as the end user to an underlying cash Term SOFR position. In accordance with hedge accounting standards, this derivative with the third-party swap dealer must remain outstanding for the duration of the hedge of the Term SOFR cash products and may not be risk managed through compression/offsetting or other means by the affiliate dealer.
offered to its borrowers would fall under the ARRC’s recommended use of a SOFR Term Rate derivative.²

3. Does the ARRC’s recommendation of the SOFR Term Rate mean that it now only recommends use of SOFR Term Rates in fallback language and does not recommend that other forms of SOFR be referenced as fallbacks in new or renegotiated contracts referencing LIBOR?

As noted in the ARRC Best Practice Recommendations Related to Scope of Use of the Term Rate, the ARRC continues to recommend use of overnight SOFR and SOFR averages for all products. While the SOFR Term Rate is the first step of the waterfall in the ARRC’s recommended hardwired fallback language for business loans, FRNs, and securitizations, the ARRC believes it is appropriate to use of a daily SOFR rate as a bilaterally-negotiated fallback where counterparties see this as feasible, have hedging requirements, and wish to better align with ISDA fallbacks and current SOFR swap market conventions.

4. What relation do these ARRC recommendations have to supervisory expectations or CME licensing agreements for the SOFR Term Rate?

Like all of the ARRC’s recommendations, whether and to what extent any market participant decides to implement or adopt any benchmark rate, including the SOFR Term rate, overnight SOFR, or SOFR averages is voluntary. The ARRC is not a supervisory body, and any supervisory expectations regarding SOFR Term Rates will determined by the relevant regulatory agencies.

Whether and to what extent the CME elects to license the use of its SOFR Term Rate consistent with the objective of ensuring a robust rate, or consistent with the ARRC’s recommendations as to scope of use, will be determined solely by the CME itself. The ARRC’s selection of the CME Group as the administrator of the ARRC-recommended SOFR Term Rates was not conditioned on the CME adapting any of its restrictions on their licensing of the SOFR Term rate for derivatives or otherwise. The ARRC identified CME Group’s submission as the strongest proposal after a thorough evaluation of responses to a public Request For Proposal (link). The ARRC evaluated proposals based on four specific criteria: technical criteria, firm criteria, public policy criteria, and calculation methodology criteria. The ARRC conclusively identified CME Group’s proposal as having most effectively met those criteria. Most important to the ARRC was that the CME SOFR Term rate would be robust, well-grounded in actual underlying transactions, and available at reasonable commercial cost to all market participants to facilitate the transition away from USD LIBOR.

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² For purposes of clarity, the ARRC believes that any U.S. institution subject to CFTC regulation that is not a CFTC-registered swaps dealer would meet these conditions, and that certain registered swaps dealers may also not make markets in the interdealer market or make two-way prices in interest rate derivatives.