May 19, 2022

ARRC Provides Update Endorsing CME 12-Month SOFR Term Rate

The Alternative Reference Rates Committee (ARRC) today provided an update, announcing its endorsement of the CME Group's forward-looking 12-month Secured Overnight Financing Rate (SOFR) term rate for certain uses in line with its Best Practice Recommendations Related to Scope of Use.

This endorsement is consistent with the ARRC's previous recommendation for use of 1-month, 3-month, and 6-month SOFR term rates produced by the CME in legacy and certain new products. At the time of the ARRC's previous endorsement of these rates in July 2021, the CME Group did not produce a 12-month SOFR term rate, and the futures markets that would underlie that rate were significantly less developed than they are now. The ARRC has taken the further continued development of CME SOFR futures markets into account in its consideration of the 12-month rate and believes that market conditions are such that an endorsement of this rate is now in line with the ARRC's key principles, restated below.

As announced in April 2021, the key principles for an ARRC-recommended forward-looking SOFR term rate are that this rate should:

1) Meet the ARRC's criteria for alternative reference rates, similar to SOFR itself;
2) Be rooted in a robust and sustainable base of derivatives transactions over time, to ensure that its use as a reference rate is consistent with best practices and the ARRC's own standards; and,
3) 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 notes that 12-month LIBOR rates are relatively less used, primarily in legacy adjustable rate mortgage (ARM) products and as an input in trade or receivables finance pricing. The ARRC therefore believes that use of the 12-month CME Term SOFR rate should be primarily directed toward use as part of a fallback in legacy products that reference 12-month LIBOR and in trade or receivables finance. As noted, in the ARRC Best Practice Recommendations Related to Scope of Use of the Term Rate, legacy contracts that have adopted the ARRC's fallback language without modification to the rate waterfall will, if the relevant tenor exists, fall back to the ARRC's recommended spread-adjusted SOFR Term Rate once the contractual LIBOR replacement date occurs.[1] For use as a replacement rate in consumer products referencing 1-, 3-, 6-, or 12-month USD LIBOR, the ARRC recommends a spread-adjusted SOFR rate based on the relevant tenor of the endorsed SOFR term rate plus a spread adjustment reflecting a 1-year transition period as discussed in the Summary of the ARRC's Fallback Recommendations. The ARRC

[1] While the ARRC-recommended fallbacks will apply to contracts that have adopted the ARRC's recommended fallback language, under the Adjustable Interest Rate (LIBOR) Act, contracts governed under U.S. laws that have not adopted the ARRC's recommended language and that otherwise do not include workable fallback language would fallback to the replacement rates to be selected by the Federal Reserve.

is working with Refinitiv to have these spread-adjusted rates published and made publicly available; an announcement on where these rates will be available will be made shortly.
For use in new contracts, the ARRC recommends the same limited scope of use it has already laid out in its Best Practice Recommendations:

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 such as floating rate notes, consumer products including adjustable rate mortgages and student loans, and most securitizations. The ARRC also recommends the use of overnight SOFR and SOFR averages in cases where a party wishes to hedge in the most efficient and transparent manner.

However, the ARRC also supports the use of the SOFR Term Rate in areas where use of overnight and averages of SOFR has proven to be difficult. Specifically:

1. The ARRC supports the use of SOFR Term Rate in addition to other forms of SOFR for business loan activity —particularly multi-lender facilities, middle market loans, and trade finance loans—where transitioning from LIBOR to an overnight rate has been difficult and where use of a term rate could be helpful in addressing such difficulties. The ARRC also recognizes that the SOFR Term Rate may also be appropriate for certain securitizations that hold underlying business loans or other assets that reference the SOFR Term Rate and where those assets cannot easily reference other forms of SOFR.
2. The ARRC does not support the use of the SOFR Term Rate for the vast majority of the derivatives markets, because these markets already reference SOFR compounded in arrears and transitioning derivatives markets to the more robust overnight risk-free rates (RFRs) is essential to ensure financial stability as emphasized by the Financial Stability Board. The ARRC recommends 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.

Market participants are encouraged to remain attuned to use of the SOFR Term Rate over time given the importance that such use continues to be proportionate to the base of transactions underlying the SOFR Term Rate, and does not materially detract from those transactions in a way that compromises the robustness of the SOFR Term Rate itself as the market evolves, as outlined in the ARRC's principles.

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 Commodity Futures Trading Commission, the Consumer Financial Protection Bureau, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the National Association of Insurance Commissioners, the New York Department of Financial Services, the Office of Financial Research, the Office of the Comptroller of the Currency, the U.S. Department of Housing and Urban Development, the U.S. Securities and Exchange Commission, and the U.S. Treasury Department. It was initially convened in 2014 to identify risk-free alternative reference rates for USD 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 it recommends for use in certain new USD derivatives and other financial contracts. It also published its Paced Transition Plan, with specific steps and timelines designed to support the voluntary 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 USD LIBOR.

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