Summary and Update of the ARRC’s Term SOFR Scope of Use Best Practice Recommendations

April 21, 2023

In July 2021, the ARRC endorsed CME Group’s Term SOFR rates and set out best practice recommendations on the scopes of use for which the ARRC believed these rates were appropriate. The endorsement added further to the set of SOFR-based rates available to market participants when preparing for the transition from LIBOR and it marked the final step in the ARRC’s Paced Transition Plan, but the ARRC recommendations have consistently emphasized that use of Term SOFR rates should, in its view, be limited to certain particular areas.¹ This document summarizes and updates the Best Practice Recommendations regarding use of Term SOFR.

The Term SOFR rates have proved to be a useful additional tool in the LIBOR transition, but they are different from overnight SOFR and the SOFR averages published by the Federal Reserve Bank of New York in that the Term SOFR rates are based on derivatives products, primarily SOFR futures markets, not directly on the overnight Treasury repo market that underpins SOFR itself. The robustness of the Term SOFR rates thus relies on the continued existence of a deep and liquid SOFR derivatives market based on overnight SOFR. The use of the Term SOFR rates therefore needs to remain limited, particularly in derivatives markets, in order to ensure that the Term SOFR rates can remain sustainably available for those cash markets that use them.

To address the financial stability risks that could result from more widespread use of Term SOFR, in endorsing the Term SOFR rates, the ARRC recommended that their use be limited to the following specific purposes:

- As a fallback rate for legacy LIBOR cash products
- For new use in business loans, and also certain securitizations that hold underlying Term SOFR assets²
- For use in derivatives only if issued to end-users to hedge cash products that reference the Term SOFR rate

For clarity, while the ARRC has recognized the use of Term SOFR in in these specific cases, it continues to recommend use of overnight SOFR and SOFR averages for all products.

Like all of the ARRC’s recommended best practices, the extent to which any market participant decides to implement or adopt any benchmark rate is voluntary. The official sector, however, has supported the ARRC’s recommendations and recommended that use of Term SOFR should be limited. The Financial Stability Oversight Council (Council) 2022 Annual Report recommendations state:

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¹ The ARRC’s Key Principles as it considered its conditions for endorsing a term SOFR rate specifically noted that the scope of use should be limited 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.
² For clarity, while the ARRC supports the use of Term SOFR in securitizations that hold Term SOFR assets, it does not recommend the use of Term SOFR in securitizations more broadly.
While the Council recognizes the usefulness of Term SOFR in certain business lending transactions, it endorses the ARRC’s recommendations to limit the use of Term SOFR in other markets and strongly encourages market participants to limit the usage of Term SOFR in derivatives and most other cash markets.

The Financial Stability Board (FSB) has likewise noted that use of rates like Term SOFR should remain limited in order for their use to be consistent with financial stability. In particular, members of the official sector have noted that the FSB has encouraged administrators of these rates to adopt the recommendations of National Working Groups, including the ARRC’s recommendations, in order to ensure that these recommendations were followed over time and that use of these rates will remain consistent with financial stability.

There has been substantial progress since the ARRC’s recommendations were first made: SOFR has now replaced LIBOR as the most widely used interest rate benchmark across both cash and derivatives products. The ARRC believes that this has established that the basic framework it laid out for use of Term SOFR has been successful. Term SOFR has been a useful tool in the business loan market, use of Term SOFR in derivatives has remained reasonably limited, and the dealers offering Term SOFR rate derivatives to end users seeking to hedge their Term SOFR loans have been able to warehouse the risk associated with such offerings, generally offering such hedges at a cost of a few basis points relative to SOFR OIS. Nonetheless, the past year of experience has raised concerns that dealers may eventually build up positions that are so large as to render them unable to warehouse further additional Term SOFR exposures. For that reason, the ARCC is now making a limited refinement to its recommended scope of use of Term SOFR, and also clarifying its standing recommendations to ensure they are clear for all market participants. The ARRC continues to believe that derivatives markets should be primarily based on overnight SOFR, and that use of Term SOFR should be limited in order to remain consistent with financial stability and a sustainable system. The ARRC has observed that hedging with Term SOFR has generally been more expensive than hedging with overnight SOFR or SOFR averages. The ARRC believes that these hedging costs should continue to be determined by competitive conditions in the market and may move higher or lower as determined by those economic conditions. In particular, this refinement is not intended in any way to restrain potential increases in hedging costs necessary to create a competitive, two-way markets in which dealers are able to lay off some of the Term SOFR risk they take on. However, the ARRC believes that this refinement, together with a better understanding of what the ARRC’s previous recommendations already provided for, will help to ensure that Term SOFR remains a useful tool in the transition away from LIBOR over the long-term in a way that remains consistent with financial stability.

The ARRC is also taking this opportunity to review and provide greater clarity to its existing Best Practice Recommendations as it has become apparent recently that certain market participants may not understand all aspects of what the recommendations do and not encompass. In this regard, the further details and examples in this document may be of use. Market participants are encouraged to continue to monitor use of Term SOFR over time given the importance that such use continues to be proportionate to the base of transactions underlying the Term SOFR rate, and does not materially detract from those

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3 Interest rate benchmark reform: Overnight risk-free rates and term rates (fsb.org)
4 Progress Report on LIBOR and Other Benchmarks Transition Issues: Reaching the finishing line of LIBOR transition and securing robust reference rates for the future (fsb.org) see also the December 2022 FSOC Public Meeting.
transactions in a way that compromises the robustness of the Term SOFR rate itself as the market evolves, as outlined in the ARRC’s principles.

The ARRC believes its recommended scope of use promotes a more stable financial system and will help to ensure that market participants do not again create a situation in which interest rate benchmarks are used in ways that are ultimately unstable and that necessitate the types of extraordinary steps that have been required to safely transition from LIBOR. The basic principle that underlines these recommendations – that use of Term SOFR should remain limited overall in order to achieve a sustainable system of reference rates consistent with financial stability – will not change, and the ARRC does not intend to revisit its Best Practice Recommendations for the use of Term SOFR, which are meant to apply as permanent recommendations for the market.
Review of the ARRC’s July 2021 Best Practice Recommendations Regarding Use of Term SOFR and Related Examples

Cash Products

In its July 2021 endorsement of CME Group’s Term SOFR rates, the ARRC noted that it supported use of Term SOFR as a fallback for legacy LIBOR cash products while recommending that most new use rely on overnight SOFR or SOFR averages. Specifically, the Recommended Scope of Use stated the following:

The ARRC has issued recommended fallback language for market participants’ voluntary use in contracts that reference USD LIBOR, with the goal of reducing the risk of serious market disruption when LIBOR is no longer usable. The ARRC made separate recommendations of language appropriate for LIBOR-based floating rate notes, bilateral business loans, syndicated loans, securitizations, residential adjustable-rate mortgages, and private student loans. These recommendations were made after widespread market consultation, which showed that the clear majority of respondents preferred to fallback to an ARRC-recommended SOFR term rate in order to support the smooth transition of legacy contracts away from LIBOR. For this reason, although the ARRC recognized that falling back to other forms of SOFR would be in line with its principles, under the recommended contract language for floating rate notes, bilateral and syndicated business loans, and securitizations, the first step of the fallback waterfall is a forward looking, SOFR-based term rate (provided one has been recommended in the appropriate tenor by the ARRC).

For new contracts, 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 recognized the use of the Term SOFR rates in areas where use of overnight and averages of SOFR had proven to be difficult. In particular, the Recommended Scope of Use recognized the following new uses of Term SOFR in cash products:

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.

To provide greater clarity to these recommendations, the ARRC is setting forth more formal definitions of the cash products it intended its recognition of new use of Term SOFR to apply to. In particular, the ARRC’s recommendations have distinguished between business loans and intercompany loans, for which the ARRC set out separate and different recommended conventions based on 30- and 90-day SOFR in advance. For the purposes of clarifying these recommendations the ARRC offers the following definitions:
An **Intercompany Loan** is any loan or other extension of credit, (i) by a company to any affiliate or subsidiary of the company or (ii) by an affiliate or subsidiary of a company to the company or to another affiliate or subsidiary of the company.

A **Business Loan** is a loan or other extension of credit that is primarily for business or commercial purposes and includes but is not limited to, whether or not syndicated to banks or other financial entities in each case: commercial loans; corporate loans; middle market loans; trade finance transactions including receivables finance/purchases and discounting; Islamic financing or lease facilities; and loans or other extensions of credit for business or other governmental purposes to non-profit enterprises, municipalities, or other governmental or public entities.

A **Business Loan** does not include:

(i) a securitization (having the same meaning given to the term “Asset-backed Security” in Section 3(a)(79) of the Securities Exchange Act of 1934, as amended, and the SEC regulations thereunder);
(ii) a credit transaction to a consumer (as such terms are defined in section 103 of the Truth in Lending Act (15 U.S.C. 1602));
(iii) (A) a security (as such term is defined under Section 2(a) of the Securities Act of 1933, as amended, and the SEC regulations thereunder) offered publicly, (B) a security offered under rule 144A or (C) any other security (e.g., a private security), unless such security is a loan or other extension of credit or the functional equivalent of a loan or other extension of credit that is primarily for business or commercial purposes of the type described above in the definition of Business Loan;
(iv) a swap agreement (as such term is defined under the U.S. bankruptcy code at 11 U.S.C. Section 101);
(v) an Intercompany Loan; or
(vi) an advance made by a Federal Home Loan Bank.

While the ARRC has made specific recommendations regarding intercompany loans, it has not made recommendations in regard to **intracompany** (meaning within a single company) pricing or transactions. However, the ARRC encourages firms, in particular larger and more sophisticated financial firms, to use

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5 Clause (iii)(C) expressly contemplates that certain instruments which are or may be viewed as securities from a statutory, regulatory, or jurisprudential perspective, nevertheless, are treated as business loans by the market and, consistent with these best practice recommendations, may use Term SOFR as a reference rate.

The ARRC recognizes that the statutory, regulatory, and jurisprudential definitions referenced in the definition of Business Loan may change over time. If material changes were to occur, the ARRC considers that existing Term SOFR business loan agreements that meet the definition of a Business Loan at the time they were entered into should appropriately be allowed to continue to reference Term SOFR. It would furthermore be appropriate to reconsider the Business Loan definition and the official sector, or an appropriate body of stakeholders working with them, should further consider whether Term SOFR should continue to be an appropriate reference rate for newly created business loans facilities.
overnight SOFR and the SOFR curve for internal fund pricing, noting that these firms do not need to use Term SOFR for this purpose and that the pricing of the SOFR curve is more liquid and transparently available than the Term SOFR curve.

Because there has also been some confusion as to how the ARRC recommendations would apply to certain structured products, for example securitizations tied to fixed-rate auto loans or credit-linked notes, the ARRC is also offering this definition of what it intends its recognition of securitizations to apply to:

A securitization is considered to have Term SOFR assets for the purpose of the ARRC’s Best Practice Recommendations if it is collateralized or serviced by assets that include self-liquidating or revolving cash-product assets that pay Term SOFR and it allows the holder of the securitization to receive payments that depend on the cash flow from those Term SOFR assets.

The underlying principle of the ARRC’s recognition of use of Term SOFR in the liabilities of a securitization is that the cash flow from the underlying Term SOFR floating rate assets in the securitization should be sufficient to service payment of a securitization’s Term SOFR liabilities. In the case of legacy LIBOR securitizations that may convert their LIBOR based liabilities to SOFR when the underlying proportion of SOFR assets reaches fifty percent (or some alternative agreed-upon replacement percentage), there will naturally be some potential mismatch between the payments of the securitization’s SOFR-based liabilities and the underlying floating rate assets (potentially a mix of SOFR and LIBOR assets, until such time as all LIBOR assets are converted). For clarity, however, going forward in new securitizations paying Term SOFR that are established after these transition issues are past, the ARRC Best Practice Recommendations would not recognize a situation in which a securitization’s Term SOFR liabilities have been structured at issuance to materially exceed the anticipated cash flows from the portion of floating rate assets (which would be expected to be predominantly Term SOFR assets) in the securitization.

In summary, while the ARRC encourages market participants to consider use of overnight SOFR and SOFR averages in all cash products, it recognizes use of Term SOFR as a fallback in legacy LIBOR cash products, in new business loans, and in securitizations holding legacy LIBOR products or new business loans referencing Term SOFR as these terms are defined in this document. The ARRC does not recognize use of Term SOFR in other cash products and does not recommend use of Term SOFR in such products.

The figure below illustrates these recommendations.
Derivatives

The ARRC’s recommended scope of use recognized the use of Term SOFR derivatives for end-user facing derivatives intended to hedge cash products that reference Term SOFR. In an accompanying FAQ, the ARRC provided details regarding this recommendation:

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

- Under the ARRC’s recommended use of Term SOFR derivatives, a direct party to a Term SOFR loan or securitization holding Term SOFR assets could enter into a Term SOFR swap, cap, swaption, or similar derivatives contract to hedge that Term SOFR cash product exposure, or a portfolio of such exposures, and could adjust or unwind that hedge over time, including through novations. For example, either a borrower or lender could enter into a Term SOFR derivative in order to hedge a Term SOFR business loan. 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 Term SOFR rate exposure with an additional Term SOFR derivative.6

- 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 into a Term SOFR swap, cap, swaption, or similar derivative as part of their services to help a borrower hedge a Term SOFR 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 offered to its borrowers would fall under the ARRC’s recommended use of a Term SOFR derivative.

The ARRC believes that some market participants may be unaware of some of the possibilities that the existing recommendation recognizes, including avenues that dealers can potentially use to lay off some of the Term SOFR risk they are now warehousing to other market participants. For example, a bank Treasurer, or a buyside firm with Term SOFR loan exposures can enter in to hedging agreements with a dealer to pay Term SOFR. For clarity, a few use cases that the ARRC considers to be in line with its July 2021 Best Practice Recommendations are provided below, although these are not meant to be exhaustive.

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6 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 a Term SOFR cash product to which the Treasury or lending desk is a direct party. 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 order to remain consistent 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.
Example Use Cases recognized under the July 2021 ARRC Best Practice Recommendations

1. A holder of a legacy LIBOR cash product asset or liability that has converted to Term SOFR through the terms of its contractual fallback or legislation seeks to hedge that product with a Term SOFR derivative. The ARRC’s Best Practice Recommendations recognize that the holder could enter into a Term SOFR derivative to hedge this position.

2. A borrower gets a Term SOFR business loan from a bank. Because the borrower is a direct party to a Term SOFR cash transaction, the ARRC Best Practice Recommendations recognize that the borrower could enter into a Term SOFR derivative (for example a swap or option) that pays a fixed rate and receives Term SOFR, to hedge their individual loan position. The borrower could also later adjust or unwind that hedge, including through a novation, as they deemed appropriate.

In addition, the ARRC recognizes the ability of a lead hedge provider that has offered an associated hedge to the borrower in a syndicated or club Term SOFR loan to enter into back-to-back Term SOFR transactions with the participant swap providers to that loan in order to distribute the Term SOFR interest-rate hedge across the participants. The purpose of such a hedge syndication should
solely be to distribute credit risk associated with the end-user trade. As noted below, ARRC Best Practice Recommendations do not support interdealer trading of Term SOFR.

The ARRC notes that in some cases borrowers to a multicurrency facility may wish to hedge a Term SOFR loan they have taken out by entering into a cross-currency basis swap, and as a derivative hedge of the Term SOFR loan this would in principal be recognized by the ARRC’s Best Practice Recommendations; however, borrowing in a foreign currency and converting to U.S. dollars through a Term-SOFR cross-currency basis swap would not be recognized, as this Term SOFR derivative transaction would not be hedging a Term SOFR loan. Instead, in such instances, the borrower would need to rely on the more widely used cross-currency basis swap market based on overnight SOFR, which is the market standard, to convert a foreign currency borrowing.

For clarity, the ARRC Best Practice Recommendations in regards to this Example would not recognize a situation in which the Term SOFR payments received from the borrower’s derivative position were larger than the Term SOFR loan being hedged by the borrower or in which the maturity of the borrower’s derivative position materially exceeded the maturity of the borrower’s Term SOFR loan. In the spirit of the Recommendations, the swapped amount and maturity profile of the borrower’s Term SOFR derivatives position would be expected to be comparable to or less than the borrower’s Term SOFR loan if it is intended to hedge the loan.

3. A lender makes a Term SOFR loan to a business. Because the lender is also a direct party to a Term SOFR cash transaction, the ARRC Best Practice Recommendations recognize that the lender could enter into Term SOFR derivatives that pay Term SOFR and received a fixed rate to hedge their Term SOFR loan positions, either individually or on a portfolio basis. For clarity, such hedging could include issuing fixed rate debt and swapping it to pay Term SOFR, so long as the swapped position was intended to hedge the lender’s Term SOFR loan portfolio -- the ARRC Best Practice Recommendations only recognize this type of strategy if it hedges Term SOFR cash exposure, not general interest rate risk or other exposures -- and any hedge position could be adjusted, unwound, or novated over time.

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7 The ARRC’s recognition of a lender hedging its Term SOFR lending on a portfolio basis extends to the ability of a Treasury department of the parent bank or a regional hub to hedge a portfolio of Term SOFR loans issued by its subsidiaries or local branches.
4. An investor purchases a loan or securitization that is linked to Term SOFR. Because the investor is a direct party to a Term SOFR cash transaction, the ARRC Best Practice Recommendations recognize that the investor could enter into a Term SOFR derivative (a swap, a basis swap, or other form of derivative referencing Term SOFR) to hedge their position and any hedge position could be adjusted, unwound, or novated over time. As in the third example, this could include issuing fixed rate debt and swapping it to Term SOFR, so long as the swap was intended to hedge the investor’s Term SOFR cash exposure -- as noted in the third example, the ARRC Best Practice Recommendations only recognize this type of strategy if it hedges Term SOFR cash exposure, not general interest rate risk or other exposures. For clarity, the ARRC Best Practice Recommendations would not recognize a situation in which the swapped amount was larger than the Term SOFR cash position being hedged by the investor. In the spirit of the Best Practice Recommendations, the swapped amount would be expected to be comparable to or less than the Term SOFR position held if it is intended to hedge the cash position.

5. A borrower gets a Term SOFR loan from a bank and an associated hedge from the bank’s affiliated dealer, which is not a regular market maker in interdealer derivatives. Because the dealer affiliate is not a market maker, the ARRC Best Practice Recommendations recognize that the bank dealer may go to an external dealer to obtain an offsetting derivative matching the derivative exposure that the bank has offered to the borrower.  

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8 For clarity, if the bank’s affiliated dealer is a market-making dealer, then the ARRC recommendations would not recognize this type of trade between the bank dealer and another dealer.
For the purposes of this document, a *market-making dealer* is any dealer that makes two-way prices in interest rate derivatives and is a market maker in the interdealer market for these derivatives in the regular course of business a *non-market making dealer* is any other dealer that does not meet these two criteria, and references to a *dealer* are intended to include both market-making and non-market making dealers. The ARRC believes that any U.S. institution subject to CFTC regulation that is not a CFTC-registered swaps dealer would meet the conditions to be a non-market making dealer, and that certain registered swaps dealers may also not make markets in the interdealer market or make two-way prices in interest rate derivatives.

6. Interdealer Term SOFR transactions (including swaps, basis swaps, options or other Term SOFR derivatives) are not recommended under the ARRC best practices. The ARRC continues to believe that the Term SOFR rate should not be used in the interdealer market, in order to avoid an outcome where SOFR futures market activity diminishes and undermines the robustness of the Term SOFR rates.

7. A firm without any Term SOFR cash product exposure issues fixed-rate debt and seeks to swap the debt to Term SOFR. Because the firm is not a direct party to a Term SOFR cash exposure, the ARRC does not recommend use of a Term SOFR derivative in this case. Instead, the ARRC recommends use of a swap based on overnight SOFR to gain exposure to floating rates in this scenario.
Refinement to the ARRC’s Best Practice Recommendations for Derivatives

The market has successfully adopted the ARRC’s Best Practice Recommendations in respect of use of Term SOFR. And, as discussed above, the current recommendations provide avenues that lenders can pursue to offset some Term SOFR risk that they take on when issuing Term SOFR hedges to their borrowers. Even so, some market participants have recently expressed the concern that under the current Best Practice Recommendations, dealers could eventually accumulate large one-sided Term SOFR positions that may reach their internal risk limits, limiting their ability to write further Term SOFR derivative business for end users. Were this to occur, it could make the cost of hedging Term SOFR prohibitively expensive or volatile, and thereby materially erode the usefulness of Term SOFR in the transition away from LIBOR.

As it has noted many times, the ARRC expects that derivatives markets should be primarily based on overnight SOFR, and that the cost of hedging with Term SOFR, as determined by competitive market conditions, may therefore be likely to be more expensive than hedging with overnight SOFR. The refinement that the ARRC is making to its Best Practice Recommendations will not change this and is not intended to do so, but the ARRC believes it will help to ensure that this cost is not prohibitively expensive or volatile in a way that shuts down the availability of Term SOFR hedging for Term SOFR business loans or for legacy LIBOR products that have fallen back to Term SOFR.

As an update to its previous recommendations, the ARRC is introducing an additional, limited, recommendation regarding Term SOFR-SOFR basis swaps: the ARRC now recognizes that a dealer may enter into Term SOFR-SOFR basis swaps with any non-dealer market participant, even if the market participant is not a direct party to a Term SOFR cash exposure.9

The ARRC is maintaining its Best Practice Recommendations related to the general use of Term SOFR derivatives. Nothing in this update is intended to either broaden or narrow other elements of the ARRC’s July 2021 Best Practice Recommendations Regarding Use of Term SOFR in derivatives. While it is recognizing a wider potential scope of use specifically for Term SOFR-SOFR basis swaps between dealers and non-dealer market participants, the ARRC continues to recommend that dealers strictly avoid trading any Term SOFR derivatives with other dealers, including Term SOFR-SOFR basis swaps. This includes any trading through interdealer brokers or other infrastructure providers that stand in the middle of trades between market-making dealers. And the ARRC continues to recommend that any use of any Term SOFR derivative other than a Term SOFR-SOFR basis swap be limited only to end-user facing derivatives intended to hedge cash products that reference Term SOFR as described above.

Example Use Cases under the Limited Refinement to the ARRC Best Practice Recommendation

8. A dealer enters into a Term SOFR swap with a Term SOFR business loan borrower and wishes to enter into a Term SOFR-SOFR basis swap with a non-dealer (e.g., a hedge fund, asset manager,

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9 This refinement of the ARRC’s recommendations is limited specifically and solely to Term SOFR-SOFR basis swaps. It does not encompass other derivatives trades, for example packaging a Term SOFR fixed-floating swap with a SOFR OIS swap to synthetically create a Term SOFR-SOFR basis swap.
pension fund, bank treasurer, or other non-dealer market participant) to offset the risk it has taken on. Because the fund or manager are not dealers, the dealer can enter into the basis swap transaction irregardless of whether the counterparty is a direct party to a Term SOFR cash transaction.

For clarity, a non-dealer market participant could also enter into the opposing position, receiving Term SOFR from the dealer rather than paying it in the basis swap, or could even enter into such a position with another non-dealer market participant, although the ARRC does not anticipate that this will be the norm.

9. While the ARRC is recognizing a wider scope of activity for Term SOFR-SOFR basis swaps, interdealer Term SOFR basis swap transactions are not recommended under the ARRC best practices. The ARRC believes that the Term SOFR rates should not be used in the interdealer market in any form.

The intent of this recommendation is to continue to keep use of Term SOFR limited in derivatives markets, while at the same time ensuring that dealers have sufficient avenues to convert Term SOFR risk they take on in the support of the hedging desires of Term SOFR business loan borrowers in a way that does not pose undue risk to the stability and robustness of the Term SOFR rate itself. The ARRC believes that this limited refinement to its Best Practice Recommendations can ensure that Term SOFR remains a sustainably useful tool in the transition from LIBOR, while maintaining its robustness in the interest of financial stability.

Nonetheless, the ARRC continues to encourage business loan borrowers to consider other forms of SOFR, especially if they wish to hedge their loan more efficiently. The overnight SOFR derivatives market is highly liquid and hedging in it should yield the lowest possible cost. Borrowers could also consider hedging a Term SOFR loan with an overnight SOFR derivative, which is likely to still create an effective hedge although it will be subject to some basis risk, or they could also consider taking out a loan based on SOFR averages set in advance, or daily simple or daily compounded SOFR set in arrears, either of which should
also be highly cost effective to hedge. The ARRC has long promoted an understanding of the range of SOFR options, and as it first noted in its User’s Guide to SOFR:

*Use of the forward-looking term rate will tend to involve more transactions costs than using SOFR... this is [not] meant to contradict the idea that the forward-looking term rate can be a useful tool for some market participants, but it is also important that they understand the likely costs as well. A number of firms will likely wish to avoid these costs and use SOFR from the start. Many other firms will likely come to the same conclusion over time as they gain experience with the new market structure and are able to update their systems to accommodate using SOFR.*

The ARRC believes that lenders can aid borrowers in making an informed choice by offering a range of SOFR options for hedged business loans, including options for daily SOFR and/or SOFR averages set in advance that are likely to be more cost effective to hedge, and setting out clearly the general cost of hedging each option.
Summary of the ARRC’s Recommended Scope of Use for Term SOFR

1. **The ARRC supports the use of Term SOFR as a fallback for legacy LIBOR cash products.** The ARRC has issued **recommended fallbacks** based on Term SOFR for implementation of its hardwired fallback language for use in floating rate notes, bilateral business loans, syndicated loans, securitizations (apart from FFELP ABS or FHFA-regulated-entity contracts), residential adjustable rate mortgages, and private student loans contracts that reference USD LIBOR.

2. **The ARRC recognizes the use of Term SOFR in addition to other forms of SOFR for new business loan activity** — including, whether syndicated or not: commercial loans; corporate loans; middle market loans; trade finance transactions including receivables finance/purchases and discounting; Islamic financing or lease facilities; and loans or other extensions of credit for business or other governmental purposes to non-profit enterprises, municipalities, or other governmental or public entities.

3. The ARRC also recognizes that the Term SOFR rates may be appropriate for securitizations that hold underlying business loans, legacy cash-products, or, potentially, other securitizations that reference the Term SOFR as assets in order for the securitization to match the payments of its liabilities to its assets.

4. The ARRC recommends the use of overnight SOFR or SOFR averages in new issuance of all other products, include floating rate notes, consumer loans, intercompany loans, and securitizations that do not otherwise have Term SOFR assets. The ARRC does not support the use of Term SOFR in these products.

5. 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. Use of the forward-looking term rate in a hedged business loan will tend to involve more transactions costs than using SOFR, and if end users know that they want to hedge their floating rate payments then it would involve fewer transaction costs to use overnight SOFR in arrears or SOFR averages in advance. To allow borrowers seeking hedged business loans an informed choice, the ARRC believes it is good practice for lenders to offer a range of SOFR options in such cases, including daily simple SOFR and/or SOFR averages and to clearly lay out the cost of the loan and the associated hedge for each option.

6. **The ARRC does not support the use of the Term SOFR 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. Accordingly, the ARRC recommends that any use of Term SOFR-SOFR basis swaps be limited to dealers facing non-dealers and that any use of other Term SOFR derivatives be specifically limited to non-dealer facing transactions intended to hedge an end user’s direct cash product exposure to Term SOFR. Apart from the recognition of certain limited and specific offsetting transactions by non-market making dealers or lead hedge providers in syndicated or club loan deals, the ARRC recommends that use of all Term SOFR derivatives, including Term SOFR-SOFR basis swaps, between dealers be strictly avoided. These limitations are intended to avoid use that is not in proportion to, or materially detracts from, the depth of transactions in the underlying derivatives market that are essential to the construction of the Term SOFR rates over time.
Accompanying Definitions

**Business Loan**: a loan or other extension of credit that is primarily for business or commercial purposes and includes but is not limited to, whether or not syndicated to banks or other financial entities in each case: commercial loans; corporate loans; middle market loans; trade finance transactions including receivables finance/purchases and discounting; Islamic financing or lease facilities; and loans or other extensions of credit for business or other governmental purposes to non-profit enterprises, municipalities, or other governmental or public entities.

A *Business Loan* does not include:

(i) a securitization (having the same meaning given to the term “Asset-backed Security” in Section 3(a)(79) of the Securities Exchange Act of 1934, as amended, and the SEC regulations thereunder);

(ii) a credit transaction to a consumer (as such terms are defined in section 103 of the Truth in Lending Act (15 U.S.C. 1602));

(iii) (A) a security (as such term is defined under Section 2(a) of the Securities Act of 1933, as amended, and the SEC regulations thereunder) offered publicly, (B) a security offered under rule 144A or (C) any other security (e.g., a private security), unless such security is a loan or other extension of credit or the functional equivalent of a loan or other extension of credit that is primarily for business or commercial purposes of the type described above in the definition of Business Loan;

(iv) a swap agreement (as such term is defined under the U.S. bankruptcy code at 11 U.S.C. Section 101);

(v) an Intercompany Loan; or

(vi) an advance made by a Federal Home Loan Bank.

**End User**: A direct party to a new Term SOFR business loan or a securitization linked to Term SOFR assets, or to a legacy LIBOR product that has converted to the Term SOFR through contractual fallback language or legislation.

**Intercompany Loan**: any loan or other extension of credit, (i) by a company to any affiliate or subsidiary of the company or (ii) by an affiliate or subsidiary of a company to the company or to another affiliate or subsidiary of the company.

**Market-Making Dealer**: any dealer that makes two-way prices in interest rate derivatives and is a market maker in the interdealer market for these derivatives in the regular course of business.

**Non-Market Making Dealer**: any other dealer that does not meet the two criteria set out in the definition of Market-Making Dealer.

**Term SOFR Assets in a Securitization**: A securitization is considered to have Term SOFR assets if it is collateralized or serviced by assets that include self-liquidating or revolving cash-product assets that pay Term SOFR and it allows the holder of the securitization to receive payments that depend on the cash flow from those Term SOFR assets.