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ARRC Issues Summary and Update of its Term SOFR Scope of Use Recommendations

Provides Detailed Summary and Examples of the ARRC's existing Recommendations and Adds a Limited Refinement with Respect to Term SOFR-SOFR Basis Swaps

The Alternative Reference Rates Committee (ARRC) today released a summary and update of its Term SOFR Scope of Use recommendations. The ARRC is releasing this summary to support understanding among market participants of the possibilities that the existing recommendations recognize in hedging Term SOFR risk. It is also updating its recommendations to include a limited refinement that will help to ensure that Term SOFR remains a sustainable and useful tool for the business loan market.

Over the last year, the market has successfully adopted the ARRC's recommendations: SOFR has become the dominant U.S. dollar interest rate benchmark, with CME Group Term SOFR rates providing a useful additional tool for the business loan market while their use has remained limited in derivatives and other cash products. The popularity of the Term SOFR rates in business lending has led dealers to take on Term SOFR risk as they have helped clients hedge these loans, and the ARRC believes that it is appropriate to recognize a further option for laying off some of this Term SOFR risk, in addition to clarifying already existing options under its recommendations, while continuing to emphasize that use of Term SOFR should remain limited overall.

The ARRC's existing recommendations recognize the ability of end users to use Term SOFR derivatives to hedge Term SOFR business loans or legacy LIBOR products that have converted to Term SOFR. The ARRC's update of its recommendations additionally recognizes the ability of end users to enter into Term SOFR-SOFR basis swaps (but not other Term SOFR derivatives) in a wider set of circumstances, even when they do not hold Term SOFR cash assets that they are seeking to hedge. This offers an additional channel through which dealers will be able to lay off some Term SOFR risk to other market participants but is expected to continue to ensure that use of Term SOFR remains limited overall. The ARRC emphasizes that it has not altered its position in respect of interdealer trading of Term SOFR, including of Term SOFR basis swaps, as such activity could compromise the robustness of Term SOFR. CME Group has recognized the ARRC's recommendation regarding interdealer trading of Term SOFR derivatives.

The Financial Stability Oversight Council has endorsed the ARRC's recommendations and its emphasis that Term SOFR should remain limited. The ARRC believes that the Term SOFR-SOFR basis swaps refinement, together with a broader understanding of the applications of the ARRC's previous best practice recommendations, 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.

Tom Wipf, ARRC Chairman and Vice Chair at Morgan Stanley, said: "The ARRC's Best Practice Recommendations on the scope of use of Term SOFR have facilitated transition in the loan market while also supporting a resilient transition broadly grounded in use of forms of overnight SOFR. The refinement incorporated today should contribute to this continued balance by providing an additional outlet to help ensure the long-run sustainability of Term SOFR, while at the same time ensuring that use of Term SOFR derivatives is sufficiently contained, in line with the recommendations of the official sector."

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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