## ARRC Best Practice Recommendations Related to Scope of Use of the Term Rate

**Background:**

In 2014, the ARRC selected SOFR as its recommended replacement rate for USD LIBOR. SOFR was selected after careful consideration of alternatives, given the robust underpinning of the US Treasury repo market following an extensive public consultation and as documented in the ARRC's Second Report. In that same report, the ARRC recognized that there could be certain conditions where adapting to an overnight rate could be more difficult and thus explicitly included a goal of producing a forward-looking term rate for use in cash products in its Paced Transition Plan. The ARRC has selected and plans to formally recommend the CME SOFR term rates (SOFR Term Rate) once the indicators are met.

This document lays out the ARRC's recommended best practices for the use of the SOFR Term Rate in contracts. The recommendations are intended to be in line with the principles set out by the ARRC,[1] that use of the SOFR Term Rate should be in proportion to the depth of transactions in the underlying derivatives market and should not materially detract from volumes in the underlying SOFR-linked derivatives transactions that are relied upon to construct the SOFR Term Rate itself over time and as the market evolves. Like all of the ARRC best practices, the extent to which any market participant decides to implement or adopt any benchmark rate is voluntary. Therefore, each market participant should make its own independent evaluation and decision about whether or to what extent any recommendation is adopted.

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.

**Use of the SOFR Term Rate in Legacy Contracts that Have Adopted ARRC Fallback Language**

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

[1] The scope of use recommendations are also in line with guidance issued by the FSB.

ARRC.[2] Accordingly, following the formal recommendation of the SOFR 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 SOFR Term Rate once the contractual LIBOR replacement date occurs.

Under the legislation recently enacted by New York State, LIBOR-based instruments governed by New York law that do not provide effective fallbacks will transition to the applicable SOFR-based rate recommended by the ARRC, the Federal Reserve Board, or the Federal Reserve Bank of New York. The ARRC expects to make recommendations for the legislation that are consistent with its existing recommended fallback provisions.

**Recommended Best Practices for Use of the SOFR Term Rate in New Contracts**

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 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.[3] The ARRC recommends that any use of SOFR Term Rate derivatives be limited to end-user facing

[2] ARRC-recommended language for consumer products refers to the rate recommended by the ARRC for such products. As with other products, consultations indicated that most market participants also preferred to fall back to a SOFR Term Rate if the ARRC had recommended one.

[3] The FSB has stated, "Because derivatives represent a particularly large exposure to most IBORs, and because these prospective RFR-derived term rates can only be robustly created if derivatives markets on the overnight RFRs are actively and predominantly used, the FSB believes that transition of derivatives to the more robust overnight RFRs is important to ensuring financial stability."

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.