



Update

Update on Term SOFR and Practical Considerations for Usage

On July 29, 2021, the Alternative Reference Rates Committee of the Federal Reserve Bank of New York (the “ARRC”) officially recommended for usage the forward-looking SOFR term rates (collectively, “Term SOFR”) published by the CME Group. With Term SOFR now ready for use, market participants should evaluate how and when to adopt Term SOFR in new and existing debt instruments and take steps to comply with the CME Group’s stated licensing requirements. Below we provide some background on Term SOFR and its development and discuss a few practical considerations for its use.

U.S. Dollar LIBOR Transition Timing

Following increasing concern about the widespread usage of inter-bank offered rates in the wake of the 2008/2009 financial crisis, regulators around the globe have pushed to transition to more robust reference rates. In the U.S., the transition away from U.S. Dollar LIBOR has been guided by the ARRC, which has published versions of recommended fallback language and best practices related to the transition. On March 5, 2021, joint statements by the U.K. Financial Conduct Authority and the ICE Benchmark Administration Limited confirmed that the frequently-used 1- and 3-month tenors of U.S. Dollar LIBOR would no longer be published (or would be deemed “not representative”) immediately after June 30, 2023. Recent statements from U.S. bank regulators have stressed that supervised institutions should stop originating new LIBOR-linked instruments by the end of 2021 and existing contracts referencing LIBOR are expected to transition on or before the anticipated cessation of publication of the most widely-used tenors of U.S. Dollar LIBOR immediately after June 30, 2023. For additional detail and background on these developments

over the prior year, please see our prior update available [here](#).

The Use Case for Term SOFR

The Secured Overnight Financing Rate (or “SOFR”) is an observed rate based on actual transactions, and is published by the Federal Reserve Bank of New York as both an overnight rate and as 30-, 90- and 180-day compounded averages of observed rates.¹ These published values do not provide a simple replacement for LIBOR, however, since they are observed values from a prior period rather than forward-looking rates like LIBOR. The financing transactions underlying the calculation of SOFR consist of overnight rather than term financing, so a forward-looking term rate is not possible to observe directly from financing transaction prices and instead requires calculation based on transactions in derivatives such as futures and swaps. Therefore, Term SOFR, as a forward-looking rate, is generally viewed as a cleaner and simpler benchmark replacement for existing contracts and products that previously referenced LIBOR. Term SOFR is the preferred “benchmark replacement” in most versions of benchmark fallback language used commonly

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¹ The Federal Reserve Bank of New York published rates are available at <https://www.newyorkfed.org/markets/reference-rates>

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in the bilateral and syndicated lending market, including versions based on ARRC-recommended fallback language.

Term SOFR Development

Until recently, one of the remaining open variables in the transition away from U.S. Dollar LIBOR has been whether and when a Term SOFR rate would be available and recommended for use by the ARRC.

Earlier this year, the CME Group began publishing its calculation of “term SOFR” rates for 1-, 3-, 6- and 12-month tenors.² After a period of evaluation as to whether the CME Group rates met certain prudential standards for a benchmark replacement rate, the ARRC formally recommended CME Group’s calculation of Term SOFR on July 29, 2021.³ The ARRC also published best practices for Term SOFR usage and recommended conventions.⁴

While most versions of benchmark fallback language used in the market allow some discretion for the lender or agent to determine whether a rate is available for use or able to be implemented, we expect the ARRC recommendation of the CME Group’s publication of Term SOFR rates to lead to widespread adoption of Term SOFR when the benchmark replacement process is triggered in contracts with benchmark fallback language that includes Term SOFR as the preferred benchmark replacement.

Practical Considerations

Licensing – The CME Group has indicated that market participants must obtain a license for “use” of CME Term SOFR Reference Rates, including by a lender for calculating interest under a loan, even if they access the CME Term SOFR Reference Rates via another data servicer provider. However, the CME Group has also specified that end users would not need a license simply to enter into a transaction referencing the CME Term SOFR Reference Rates.⁵ The CME Group does not plan to charge for such licenses until 2026, but is encouraging market participants that plan to use Term SOFR in a way that would require a license to apply for that license as soon as possible.

Hedging – Due to trading conventions, it is expected that most SOFR-based derivatives transactions will reference compounded SOFR in arrears rather than Term SOFR, though it is expected that Term SOFR derivatives products will be

available for hedging by end users. However, for market participants with existing LIBOR-linked hedge transactions, it is likely that those transactions will fall back to compounded SOFR pursuant to standard ISDA benchmark replacement language, which may create a mismatch if the underlying debt instrument specifies Term SOFR as the preferred benchmark replacement. While any quantitative deviation between Term SOFR and compounded SOFR is expected to be minimal, this mismatch may be significant for larger transactions or portfolios, or situations where hedge matching is relevant for tax, accounting or other concerns.

Not Credit Risk Sensitive – While Term SOFR more closely matches the term structure and forward-looking features of LIBOR, as a calculation based on a secured overnight financing rate, it does not match the credit risk sensitive nature of LIBOR as an unsecured term rate. It is unclear whether any of the available credit risk sensitive rates will emerge as significant contenders to SOFR-based lending.

Term SOFR Transition Event – Certain versions of benchmark fallback language allow for the possibility of a second step fallback to Term SOFR (often defined as a “Term SOFR Transition Event”) following an earlier initial transition where Term SOFR was not yet available. Therefore, market participants should consider whether any discretionary or mandatory benchmark replacement is triggered by the ARRC recommendation of Term SOFR described above, and whether there any related notice requirements triggered by Term SOFR availability.

Longevity of Term SOFR. The ARRC has cautioned that use of Term SOFR must remain consistent with prudential principles established by the ARRC, and should not materially detract from volumes in the underlying SOFR-linked derivatives transactions that are relied upon to construct the Term Rate itself over time.⁶ Regulators may at some point in the future determine that the Term Rate is no longer representative, triggering a new benchmark replacement. As the market’s experience with LIBOR has proven, there’s no guaranty that any rate will be around forever; Term SOFR may be particularly vulnerable given that its quality as a benchmark rate depends on the robustness of the underlying market in SOFR derivatives.

If you have questions regarding usage of Term SOFR or the LIBOR transition generally, please reach out to the authors of this alert or your regular Polsinelli contact.

² Current data available at <https://www.cmegroup.com/market-data/cme-group-benchmark-administration/term-sofr.html#>

³ The ARRC press release is available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/ARRC_Press_Release_Term_SOFR.pdf

⁴ The ARRC press release with links to recommended loan conventions and best practices is available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/ARRC_Press_Release_Term_Rate_Scope_and_Conventions.pdf

⁵ Additional information about the CME Term SOFR Reference Rates and licensing is available at <https://www.cmegroup.com/market-data/files/cme-term-sofr-reference-rates-faq.pdf> and for Loan Syndications and Trading Association (LSTA) members at <https://www.lsta.org/news-resources/time-to-get-your-cme-term-sofr-license/>

⁶ The Alternative Reference Rates Committee, “ARRC Best Practice Recommendations Related to Scope of Use of the Term Rate”, updated August 27, 2021, available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/ARRC_Scope_of_Use.pdf