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ARRC Releases White Paper Regarding SOFR – The New U.S. Dollar LIBOR Alternative

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In June 2017, the Alternative Reference Rates Committee (the "ARRC"), a group of private-market participants convened by the Federal Reserve Board and the Federal Reserve Bank of New York, selected the Secured Overnight Financing Rate ("SOFR") as the preferred alternative to U.S. dollar LIBOR. SOFR is determined based on overnight transactions in the U.S. dollar Treasury repo market and therefore is a broad measure of the cost of borrowing cash overnight collateralized by U.S. Treasury securities. On April 3, 2018, the New York Fed began publishing SOFR. A little more than a year later, on April 22, 2019, the ARRC released "A User's Guide to SOFR," a white paper exploring different ways market participants could use SOFR in cash products and laying out the relevant considerations, such as transactional costs and ease of hedging, in choosing among the different methodologies.[1]

- **SOFR and the development of term rates:** The ARRC white paper advises those who are able to use SOFR not to wait for term rates to develop before transitioning from LIBOR. The white paper notes that, while the overnight Treasury repo market is "extraordinarily deep," the existing term repo markets in the U.S. are too thin to produce reliable, robust, transactions-based term rates on a daily basis. The ARRC thus has proposed to have a private administrator construct a forward-looking term rate based on SOFR derivatives markets once they develop sufficient liquidity. The ARRC's proposal contemplates a forward-looking term rate based on a combination of SOFR futures and overnight index swap transactions. The white paper notes that SOFR derivative markets have developed quickly and should have liquidity sufficient to construct a forward-looking term rate in the future, but the timing is uncertain. While these term rates are being developed, the ARRC notes that it should be possible to use compound or simple averages of SOFR over desired interest periods as an effective replacement for LIBOR in most cash products.

- **Averaged overnight rates:** The white paper notes that many financial products that reference an overnight rate as the benchmark already explicitly or implicitly use some kind of average of the overnight rate in determining the floating-rate payments owed. An averaged overnight rate has been shown to smooth out volatility and daily fluctuations in overnight market rates, thereby more accurately reflecting interest rate movements over a given period of time. The New York Fed has indicated that it plans to begin publishing averages of SOFR by the first half of 2020.

- **Simple versus compound average:** The white paper addresses the pros and cons of using a simple versus a compound average of SOFR. Using simple interest conventions may be more straightforward, given that many systems—such as the United States loan and short-term floating rate note systems using overnight LIBOR, for example—already are set up to accommodate them, but compound interest more accurately reflects the "time value of money," which becomes a more important consideration as interest rates rise, and can be more easily hedged. Overall, the ARRC notes that the differences among these conventions generally are small, and other terms can be adjusted to equate the overall cost.

- **Timing of the average interest calculation:** The white paper also addresses the different possible averaging periods to be used for calculating the average SOFR. It describes in detail the different variations on the "in advance" and "in arrears" methodologies in calculating interest. It also describes hybrid models, such as setting payments in advance but accruing principal and interest in arrears. Market participants may wish to consider factors such as operational ease, certainty about future payment obligations, potential timing mismatches with other payments, and ease of hedging in choosing which approach to use.

With LIBOR's publication guaranteed only through 2021, the ARRC white paper provides much needed data points and recommendations to market participants as they examine LIBOR exposures in their own portfolios, including existing fallback language in their derivatives, loans, securitization, and other financing contracts, and begin to familiarize themselves with SOFR.

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[1] The Alternative Reference Rates Committee, A User's Guide to SOFR (2019), https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Users_Guide_to_SOFR.pdf.