ARRC Releases Consultation on Potential Spread Adjustment Methodologies

Seeks Input on the Calculation of Spreads to Account for the Differences between SOFR and LIBOR; Consultation is Open for Feedback through March 6

The Alternative Reference Rates Committee (ARRC) today released a consultation on spread adjustment methodologies for cash products referencing U.S. dollar (USD) LIBOR. These spread adjustments are intended for use in USD LIBOR contracts that have incorporated the ARRC's recommended hardwired fallback language, or for legacy USD LIBOR contracts where a spread-adjusted SOFR can be selected as a fallback.

The consultation proposes a static spread adjustment that would be implemented at a specific time on or before USD LIBOR's cessation and would make the spread-adjusted version of the Secured Overnight Financing Rate (SOFR) comparable to USD LIBOR. In doing so, the spread adjustment would minimize the expected change in the value of contracts as a result of shifting from USD LIBOR to SOFR. SOFR is the ARRC's recommended alternative to USD LIBOR. The ARRC has committed to making sure that its recommended spread adjustments and the resulting spread-adjusted rates are published and made publicly available.

"A spread adjustment will minimize changes in value that would result from an inevitable switch to SOFR at the point of transition," said Tom Wipf, ARRC Chair and Vice Chairman of Institutional Securities at Morgan Stanley. "I urge market participants to closely assess the different methodological options and provide feedback, to help the ARRC determine which approach is the most fair and precise."

The finalized methodologies would be applied to each USD LIBOR tenor separately at the time of a trigger event. This means that the final recommended spread adjustments for each USD LIBOR tenor may differ, though the underlying methodology for calculating them would be the same.

To help market participants evaluate potential methodologies, the consultation presents indicative, historical analysis to demonstrate how different methods would have worked in the past. The consultation also poses questions regarding methods for calculating the long-run level of the spreads, the time period of data used to estimate the long-run level, and the speed at which the spread adjustment should be expected to adjust from the last value of USD LIBOR to a long-run level, called a "transition period" in the consultation.

Submitting Feedback about this Consultation

The ARRC welcomes responses to the consultation from the widest possible range of stakeholders. The release of the consultation marks the start of a public comment period during which the ARRC intends to work closely with stakeholders to solicit and incorporate their input. Following this comment period, the ARRC plans to recommend spread adjustments that would apply to its fallback recommendations.

Market participants may submit responses to the consultation questions by email to the ARRC Secretariat (arrc@ny.frb.org) no later than March 6, 2020. Please provide only one response per institution. Please attach your responses in a PDF document and clearly indicate "Consultation

Response” in the subject line of your email. Comments will be posted on the ARRC’s website as they are received without alteration except when necessary for technical reasons.

Comments will be posted with attribution unless respondents request anonymity. If your institution is requesting anonymity, please clearly indicate this in the body of your email and please ensure that the PDF document you submit is anonymized. Questions regarding the consultations should be sent to the ARRC Secretariat (arrc@ny.frb.org) and will not be posted for attribution.

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 Consumer Financial Protection Bureau, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Office of Financial Research, the Office of the Comptroller of the Currency, the Commodity Futures Trading Commission, the 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 the SOFR as the rate that represents best practice 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 encourage adoption of the 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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