May 6, 2021

Market Indicators that Would Support an ARRC Recommendation of a Forward-Looking SOFR Term Rate

The Alternative Reference Rates Committee (ARRC) has identified a set of market indicators that it will consider in recommending a forward-looking Secured Overnight Financing Rate (SOFR) term rate. The ARRC has long recognized that a forward-looking term SOFR rate will be a useful tool to support the transition away from LIBOR. The publication of the indicators builds on the ARRC's March 23 update, ongoing ARRC discussions, and term rate principles, and provides clear guidance that would allow the ARRC to recommend a SOFR-based term rate relatively soon. The indicators are designed to measure progress in establishing deep and liquid SOFR derivatives and cash markets—which are essential to a robust and stable term rate.

The market indicators the ARRC will consider in order to recommend a term rate are:

1. Continued growth in overnight SOFR-linked derivatives volumes
2. Visible progress toward ARRC best practices designed to deepen SOFR derivatives liquidity:
    a. Offering electronic market-making and execution in SOFR swaps and swap spreads
    b. Changing the market convention for quoting USD derivative contracts from LIBOR to SOFR
    c. Making markets in SOFR-linked interest rate volatility products (including swaptions, caps, and floors)
3. Visible growth in offerings of cash products, including loans, linked to averages of SOFR, either in advance or in arrears.

These outlined steps should help further establish SOFR derivatives markets, and provide borrowers a range of choices based on SOFR.

Background

When the ARRC was convened by the Federal Reserve Board and the Federal Reserve Bank of New York, it was asked to consider the range of existing and potential reference interest rates and to identify a risk-free (or nearly risk-free) rate or rates that in the consensus view of the members would represent best practice based on a range of factors. Those factors included the liquidity of the underlying market, the likely robustness of the market over time, usefulness to all market participants, the ability to produce and maintain the alternative rates, and whether the identified alternative rates are consistent with the *Principles for Financial Benchmarks* outlined by IOSCO. Based on these considerations, the ARRC selected the Secured Overnight Financing Rate (SOFR) at its recommended rate and developed its Paced Transition Plan to encourage the use of SOFR on a voluntary basis.

As part of the Paced Transition Plan, the ARRC stated that if SOFR futures and/or OIS markets were active and robust enough, then a forward-looking term SOFR reference rate could be created based on those markets as a final step in order to aid the transition from LIBOR. In laying out the Paced Transition Plan, the ARRC recognized that contracts for loans or other cash products could be written on either a backward-looking average of SOFR or on an "in arrears" arrangement in which the floating rate is based on realized average of the overnight rate over the period (these were described further in the ARRC's User's Guide to SOFR). The ARRC acknowledged that these uses of SOFR might pose difficulties to some customers who have grown accustomed to, or whose systems require, a pre-determined, forward-looking floating rate payment structure. The ARRC's User's Guide laid out some specific uses where it believe that a forward-looking term SOFR could be most productively used, in particular as a fallback for legacy cash products referencing LIBOR and in loans where the borrowers otherwise have difficulty in adapting to the new environment.

The ARRC has also previously stated that:

- The Paced Transition Plan could only be successfully implemented if ARRC members and key end users and other market participants recognize their own interest in voluntarily helping to establish markets for SOFR instruments and building a critical mass of liquidity in them, and that, to the extent that these goals are achieved quickly, a term reference rate based on SOFR derivatives could potentially be established earlier than the end of 2021.
- While the term rates can be a useful tool for some and an integral part of the new ecosystem, their use also needs to be consistent with the functioning of the overall financial system.
- For the framework underlying the term rate to work well and to have enough underlying transactions to construct a term rate, broker-dealers offering clients contracts on a term reference rate for other non-derivatives products would still need to hedge the positions in the underlying SOFR OIS or futures market, while the forward-looking term rate could provide a useful "front end" to their clients.

Recent Developments

Although SOFR derivatives markets are growing, the ARRC has noted that most transactions continue to reference LIBOR and this has not yet allowed the ARRC to recommend a forward-looking SOFR term rate. The ARRC had previously set out best practices, designed to prepare for the LIBOR transition and increase SOFR derivatives liquidity, but many market participants have not yet met the timelines the ARRC had envisioned, which has hampered growth in SOFR derivatives markets. In addition, many members of the ARRC's nonfinancial corporate working group have reported that lenders are not either offering or communicating with them about the availability of SOFR-based loans, although they wish to begin borrowing based on a range of SOFR options. The issuance of SOFR-based cash instruments will help build demand for SOFR-linked derivatives activity that are the foundation for a forward-looking term rate.

In light of these developments and in order to provide clarity to the market, the ARRC announced the formation of a task force on March 23 to help the committee to swiftly set out the liquidity and other criteria that it believes are necessary for it to recommend a forward-looking SOFR term rate.

On April 20, the ARRC announced key principles that would inform its considerations of a forward-looking SOFR term rate and guide the conditions necessary for it to recommend one. The key principles for an ARRC-recommended forward-looking SOFR term rate, are that this rate should:

1. Meet the ARRC's criteria for alternative reference rates, similar to SOFR itself;

2. Be rooted in a robust and sustainable base of derivatives transactions over time, to ensure that its use as a reference rate is consistent with best practices and the ARRC's own standards; and,

3. Have a limited scope of use, to avoid (i) use that is not in proportion to the depth and transactions in the underlying derivatives market or (ii) use that materially detracts from volumes in the underlying SOFR-linked derivatives transactions that are relied upon to construct a term rate, making the term rate itself unstable over time.

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In line with its March 23 statement, the ARRC has worked to set out criteria that it believes are necessary for it to recommend a forward-looking term SOFR rate.

Specifically, guided by its principles for a forward-looking term SOFR, the ARRC has identified a set of market indicators that it will consider in recommending a forward-looking SOFR term rate. The ARRC has long recognized that a forward-looking term SOFR rate will be a useful tool to support the transition away from LIBOR. The publication of the indicators builds on the ARRC's March 23 update, ongoing ARRC discussions, and term rate principles, and provides clear guidance that would allow the ARRC to recommend a SOFR-based term rate relatively soon. The indicators are designed to measure progress in establishing deep and liquid SOFR derivatives and cash markets—which are essential to a robust and stable term rate.

The market indicators the ARRC will consider in order to recommend a term rate are:

1. **Continued growth in overnight SOFR-linked derivatives volumes**
2. **Visible progress toward ARRC best practices designed to deepen SOFR derivatives liquidity:**
    a. **Offering electronic market-making and execution in SOFR swaps and swap spreads**
    b. **Changing the market convention for quoting USD derivative contracts from LIBOR to SOFR**
    c. **Making markets in SOFR-linked interest rate volatility products (including swaptions, caps, and floors)**
3. **Visible growth in offerings of cash products, including loans, linked to averages of SOFR, either in advance or in arrears.**[1]

These outlined steps should help further establish SOFR derivatives markets, and provide borrowers a range of choices based on SOFR.

[1] SOFR in advance averages are published daily by the New York Fed available here.

As noted above and as stated in its recent principles, the ARRC believes that derivatives should reference SOFR rather than a SOFR term rate in order to ensure that use of the term rate in cash markets in consistent with a stable market structure. While the ARRC has not yet recommended any forward-looking SOFR term rate or administrator, the ARRC does note that CME recently began the publication of such a rate and has said that it will not license its term rates for use in derivatives for at least two years—a restriction that is in line with the ARRC principles. The ARRC would hope that any other potential producers of SOFR term rates would adopt similar restrictions and will factor a decision to include these types of restrictions into its deliberations as it moves to select the specific administrator who would produce the term rates that would be recommended by the ARRC, as referenced in the ARRC's fallback recommendations and recent New York State legislation.[2]

The ARRC believes the indicators set out above are achievable and can be realistically met relatively soon if market participants actively move away from LIBOR, which would allow the ARRC to recommend a forward-looking SOFR term rate administrator. In order to prepare for such a recommendation, the ARRC is working to identify a set of best practice recommendations on the scope of use of the term rate that are consistent with its earlier statements on areas where it believes a term rate can be most productively used.

[2] For both contracts that incorporate the ARRC's fallback language and those to which New York's recent legislation applies on a mandatory basis, the rate recommended by the ARRC for a given cash product and tenor will be the successor rate when LIBOR ceases.