CADWALADER

Cabinet News and Views

Informed analysis for the financial services industry

ARRC Updates its Recommendations for Use of Term SOFR

By **Lary Stromfeld**
Partner | Financial Regulation

The Alternative Reference Rates Committee (ARRC) announced three updates to its recommendations for the use of Term SOFR.

First, the ARRC clarified the scope of "business loans" that may be hedged with Term SOFR swaps. Second, the revised recommendations recognize that end users may enter into Term SOFR basis swaps even when they do not have exposure on Term SOFR cash assets. Third, the ARRC clarified when the liabilities (*i.e.*, the securities) issued in a securitization could use Term SOFR.

The announcement first differentiated between "business loans" (for which Term SOFR may be appropriate) and intercompany loans (for which the recommendation remains 30- or 90-day SOFR in advance). A Term SOFR swap may be used to hedge a business loan that is primarily for a business or commercial purpose. The announcement gives several itemized examples, including a syndicated loan or trade finance transaction. The recommendation does not include business loans that are securities offered publicly or in 144A transactions or securities sold in private transactions unless, in the latter case, it is the "functional equivalent" of a loan that would otherwise be within scope of the recommendations. This last point tries to capture certain syndicated business loans irrespective of their treatment for certain regulatory purposes.

The announcement also expanded the market for Term SOFR derivatives by recognizing that dealers could enter into Term SOFR-SOFR basis swaps with end users who are not hedging their exposure on a Term SOFR cash product (which was the case in the ARRC's earlier recommendations). The ARRC was very clear that the broader recommendation did not cover either end users entering into Term SOFR derivatives that are not basis swaps or dealers entering into any Term SOFR derivatives with other dealers. Rather, this narrow expansion is intended to address "concerns that dealers may eventually build up positions that are so large as to render them unable to warehouse further additional Term SOFR exposures."

Finally, the ARRC recognized that Term SOFR could be used for the securities issued by a securitization that holds Term SOFR assets so that the cashflows would be better matched. However, “after these transition issues are past,” the ARRC would not recommend the use of Term SOFR “in a situation in which a securitization’s Term SOFR liabilities have been structured at issuance to materially exceed the anticipated cash flows from the portion of floating rate assets (which would be expected to be predominantly Term SOFR assets) in the securitization.”

In a related development, the licensing agreement for use of CME Term SOFR is expected to be revised to be consistent with these updated ARRC recommendations, thus making such limitations a part of the contract under which market participants may use CME Term SOFR.
