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Term SOFR: A Viable Reference Rate Alternative?

Key Points

- With the US Alternative Reference Rate Committee's ('ARCC')[1] endorsement and increasing market adoption, the Term Secured Overnight Financing Rate ('Term SOFR') has become a viable reference rate for USD denominated debt facilities, and can be suitable for market participants use in new and transitioning USD loan contracts
- The volume of transactions referencing Term SOFR is growing, and we expect this trend to continue
- Market participants are encouraged to review their outstanding USD LIBOR exposures with a view to transitioning to Risk Free Rates ('RFR') ahead of the discontinuation of all remaining USD LIBOR tenors on 30 June 2023

Whilst the formal recommendation by ARRC was made on 29 July 2021, the use of Term SOFR in loan contracts has gained momentum in Q122 due to the inability to issue new USD LIBOR contracts from 1 January 2022, and a push toward transitioning existing legacy USD LIBOR exposures to RFR's.

The purpose of this note is to provide clients with an overview of Term SOFR as a viable RFR. While there are various ways to calculate interest using RFRs this note focuses on highlighting the pros and cons of using Term SOFR vs. SOFR Compounded in-arrears. The below is provided for information purposes only.

Comparison of Term SOFR vs. SOFR Compounded in-arrears

RFR	Term SOFR	SOFR Compounded in-arrears
Rate Type	Term Rate (available in 1, 3, 6, 12M tenors)	Overnight, theoretically able to be compounded for any length of time
Benchmark Administrator	CME Group Benchmark Administration Limited	Federal Reserve Bank of New York
Determination and Notification of Interest	Forward-looking rate: interest payable can be determined before the commencement of the interest period (T-2)	Backward-looking rate: interest payable can be determined after the appliable lookback period prior to the end of the interest period
How are rates calculated?	Rates are calculated based on 1-month and 3-month SOFR futures contracts traded on CME, using a methodology developed by the US Federal Reserve	Daily average of US Treasury-collateralized overnight repurchase agreement (i.e., 'repo') transaction data collected by the US Federal Reserve

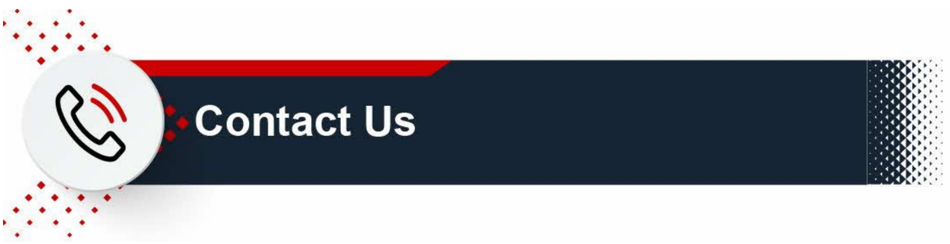
[1] US Alternative Reference Rate Committee – a committee of private market participants convened by the US Fed to support the transition from LIBOR to SOFR.

RFR	Term SOFR	SOFR Compounded in-arrears
How do we derive Adjustment Spread?	For current USD LIBOR loans transitioning to Term SOFR upon the cessation of USD LIBOR, ARRC recommends using the ISDA Fallback Adjustment Spread fixed on 5th March 2021[2] For Day 1 Term SOFR loans, we observe that the market is converging toward pricing any applicable Adjustment Spread into the Margin applicable to the facilities	For current USD LIBOR loans transiting to SOFR in-arrears upon the cessation of USD LIBOR, ARRC recommends using ISDA Fallback Adjustment Spread fixed on 5th March 2021[3] For Day 1 SOFR in-arrears loans, we observe that the market is converging toward pricing any applicable Adjustment Spread into the Margin applicable to the facilities

Pros and Cons Analysis

	Term SOFR	SOFR Compounded in-arrears
Pros	• Easily adoptable: the characteristics of Term SOFR are similar to USD LIBOR and therefore it is expected minimal changes would be required to operationalize Term SOFR • Straightforward application for short term products or services requiring term rates (e.g., Trade Financing) • Certainty of rate applied to Interest Period: similar to USD LIBOR, the amount of interest payable by a counterparty will be known 2 days prior to the start of an Interest Period	• Aligned with other regulator approved methodologies (e.g., SORA, SONIA) • Well established market conventions with increased SOFR market use due to the fast-approaching discontinuation of all USD LIBOR settings at end June 2023 • Derivatives market is well developed which provided clients with an ability to enter into hedging arrangements for their loans
Cons	• Inconsistency across currencies: Term RFR rates are not published for all currencies, and where they are (e.g., Term SONIA) they may not necessarily be recommended for use in loan products • Lower liquidity in the Term RFRs derivatives market: which may make it uneconomic for counterparties to hedge their interest rate risk • Not all lenders may be able to support Term RFR adoption	• Harder to implement given backward looking mechanisms which require operational implementation / adjustments • Unsuitable for certain trade financing arrangements

We encourage all clients yet to transition their IBOR portfolios, to reach out to their Relationship Manager to discuss the available options to transition to Risk Free Rates.



[2] https://www.bloomberg.com/company/press/bloomberg-notice-on-ibor-fallbacks/
[3] As above

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