TD Securities

Market Musings

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One Giant Leap for Term SOFR

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- Today the ARRC released a best practice recommendation on the scope of use for the SOFR Term Rate and loan conventions referencing term SOFR and SOFR compounded in advance. Note that term SOFR is the first step of the waterfall for ARRC fallbacks as well as for legacy products under NY State legislation.
- Today's best practices focus on new products and allow the usage of a SOFR term rate where the transition to overnight SOFR has been difficult, such as in loans or securitizations where the underlying assets reference term SOFR.
- For derivatives, the ARRC expects the vast majority of new contracts to reference overnight SOFR in arrears. ARRC envisages the use of term SOFR derivatives only when the end-user is hedging a cash product linked to term SOFR. Since dealers will need to warehouse the basis risk between term SOFR and overnight SOFR in arrears, this will likely result in higher transaction costs and less liquidity in term SOFR derivatives.
- For investors hedging cash products referencing SOFR averages or expressing a view on interest rates, regular SOFR swaps (i.e., SOFR compounded in arrears) should be the most efficient instrument.
- CFTC's MRAC SOFR First initiative launches next week on July 26th, which will result in a shift in interdealer trading conventions for USD linear swaps from Libor to SOFR. We expect the ARRC to endorse term SOFR soon after since ARRC Chair Wipf has previously stated an endorsement will occur "in days not weeks" following SOFR First. Note that ARRC has already picked CME to be the term SOFR vendor, and CME is publishing 1m, 3m, and 6m term SOFR.

ARRC Releases Term SOFR Scope of Use

Today the Alternative Reference Rates Committee (ARRC) released a best practice recommendation on the scope of use of the forward-looking SOFR Term Rate and loan conventions referencing term SOFR and SOFR averages (compounding in advance). Note that forward-looking term SOFR (which we will refer to as term SOFR in this note) is the first step of the waterfall for ARRC fallbacks as well as for legacy products under NY State legislation.

Today's best practices focus on new products and the main takeaway from the ARRC guidance is for the use of a term SOFR where the transition to overnight SOFR has been difficult. This includes products such as some business loans (where the conventions released today can help), securitizations, and derivative hedging of these products. Note that ARRC has and continues to recommended using existing forms of overnight SOFR and SOFR averages where possible, but today's announcement addresses those segments that have not transitioned so far. We believe that term SOFR may also help slow the shift toward credit sensitive rates (CSRs) in some parts of the market since it provides a forward-looking rate and the payment amount can be known in advance.

The derivative guidance is consistent with the Financial Stability Board (FSB) position that most derivatives should reference the overnight rate. However, in the case of hedging of cash products linked to term SOFR, a term SOFR derivative might be desired by end users. Meanwhile, the interdealer market will continue to reference overnight SOFR in arrears. In the case of end users hedging term SOFR linked cash products, we would expect higher transaction costs in term SOFR derivatives compared with regular SOFR derivatives (which reference overnight SOFR) as dealers will need to warehouse the basis risk between term SOFR and overnight SOFR in arrears. For investors hedging a cash product referencing SOFR averages or expressing a view on interest rates, regular SOFR swaps (i.e., SOFR compounded in arrears) should be the most efficient instrument. A regular SOFR swap will match cash flows more closely and will be more liquid.

Figure 1 summarizes the ARRC's recommended usage of overnight or SOFR term rates by product. Note that ARRC is not a regulatory body and the scope of use should be viewed as a guideline. Regulators can choose to issue specific guidance on this issue for their supervised entities. As we discussed in an earlier note, the FHFA recently issued a Supervisory Letter to the FHLBs regarding the use of alternative rates which include term SOFR and credit sensitive rates.

Figure 1: ARRC Best Practices on SOFR Usage by Product

Product	Averages of Overnight SOFR	SOFR Term Rate
Derivatives	Vast majority	Limited to end-user hedging of cash products referencing term SOFR
Consumer Loans (e.g., ARMs, Student Loans)	All	-
Business Loans	Some	Particularly multi-lender facilities, middle-market loans, trade finance loans
Bonds (e.g., FRNs)	All	-
Securitizations	Most	Securitizations that hold underlying business loans or other term SOFR assets

Source: ARRC, TD Securities

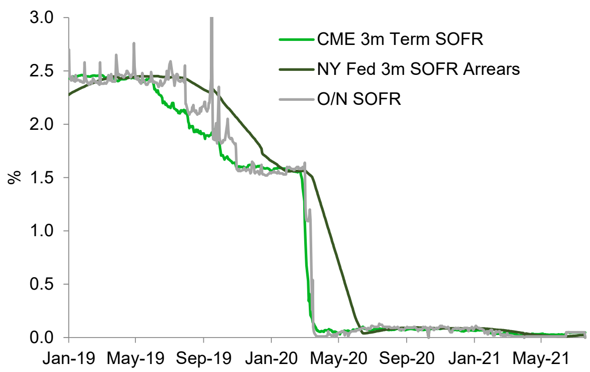
Scope of Use is the Second to Last Step in the Term Rate Saga

Today's release of the scope of use for term SOFR marks a key step in the long debate about the term rate that the ARRC and individual working groups focused on benchmark transitions in other jurisdictions have grappled with. The demand for the term rate is understandable — it is the fallback for many cash products as well as in the NY State legislation for tough legacy Libor products. In addition, for products where payment needs to be known in advance or one where a forward-looking rate is important (such as revolvers), the term rate is a critical component to help transition away from Libor. Figures 2 and 3 show that while term SOFR and average SOFR in arrears tend to trend together, they can vary during Fed rate cycles.

But the biggest sticking point in the debate over the use of the SOFR term rate has been the extent of usage. Ultimately the term rate relies on sufficient liquidity in the overnight market to be a robust and reliable benchmark. ARRC wants to prevent an "inverted pyramid problem" (that existed with Libor) where a vast majority of products use a term SOFR rate that itself relies on few overnight transactions. Thus, ARRC has understandably sought to limit the usage of term SOFR.

The ARRC approach to getting a term rate has gone through a few twists and turns over the last few months. ARRC had initially envisaged getting term SOFR officially approved by mid-2021. However, in March 2021 ARRC suggested that there would be no guarantee that term SOFR would be endorsed by the ARRC by June 2021. SOFR derivative volumes were not very high ("market indicator") and there was no clear consensus about the scope of use for term SOFR. In April the ARRC released a statement of principles highlighting what it would take for them to endorse term SOFR and the CME was endorsed as the term SOFR provider in May. Today's scope of use is a key step in limiting the usage of term SOFR in cash and derivative markets, and the SOFR First change in convention should help meet the "market indicator" for term SOFR endorsement. Thus, we think the term SOFR recommendation will occur in coming days.

Figure 2: SOFR Averages and Term SOFR are Similar But More Smooth Than Overnight SOFR



Note: NY Fed 3m SOFR in arrears is delayed by 3m. Term SOFR is 3m ahead. O/N SOFR spiked to 5.25% on 9/17/2019.
Source: Bloomberg, TD Securities

Figure 3: Term SOFR and Average SOFR in Arrears Tend to be Similar When Fed Funds Rate is Unchanged

Period	Statistic	3m Libor vs CME 3m Term SOFR	3m Libor vs. NY Fed 3m SOFR	O/N SOFR vs. O/N Libor
Jan 2019 - Aug 2020	Max	139.2	140.3	28.0
	Min	-2.5	1.5	-309.5
	Average	30.2	40.5	-3.7
Sep 2020 - Jul 2021	Max	26.5	24.6	7.4
	Min	11.6	12.5	-2.9
	Average	16.8	17.2	2.7

Note: Both 3m Libor and 3m CME term SOFR rate have lagged 3 months.
Source: Bloomberg, TD Securities

Next Step: ARRC Term SOFR Endorsement After SOFR First

As discussed above, we expect ARRC to endorse term SOFR in the very near term. At a SOFR symposium last month and earlier today, ARRC Chair Tom Wipf stated that an ARRC recommended term SOFR will occur "in days not weeks" following the first step of the SOFR First initiative on July 26th. Note that this date will shift trading conventions for Libor linear swaps to SOFR, with dealers set to begin quoting all interdealer linear derivatives using SOFR as the base rate. Dealers are then expected to encourage clients to move their activity to SOFR as well. Note, however, that the SOFR First scope currently does not include basis swaps, FRAs, and single-period swaps, but may be addressed by MRAC later this year.

The FCA and Bank of England also put out an announcement supporting the SOFR First Initiative. The FCA engaged with and surveyed UK market participants in the USD swaps market, including liquidity providers and interdealer brokers and identified strong support for a change in the interdealer trading conventions. Note that the July 26th shift will be only the first step of the SOFR First transition, with the ARRC recently expanding the scope to address linear swaps, cross currency basis swaps, nonlinear derivatives, and other exchange traded derivatives.

We expect ARRC to formally recommend term SOFR very soon after July 26th. Note that CME has already been chosen as the vendor, and they are publishing 1m, 3m and 6m term SOFR. At the ARRC's SOFR Symposium earlier today CME's Agha Mirza mentioned that end-user hedging related usage of term SOFR derivatives will most likely be allowed (a formal announcement is forthcoming). Note that currently CME does not license term SOFR for derivatives, but it sounds like that will change for end user hedging.

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Global Macro

Region	Publication	Date
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	Week Ahead: Canada Macro Market Movers	19 Jul
	Week Ahead: US Macro Market Movers	19 Jul
Commentary	Trading the ECB	21 Jul
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