

Interest Rates Watch: Key LIBOR Replacement Milestone – ARRC Formally Recommends Term SOFR

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Welcome back to our *Interest Rates Watch* series, developed to provide timely updates and practical advice on developments related to interest rates and benchmarks on a regular basis. As always, we are here to help.

On July 29, 2021, the Alternative Reference Rates Committee (the ARRC), the working group backed by the United States Federal Reserve and tasked with recommending a replacement for US dollar (USD) LIBOR, formally recommended the CME Group's forward-looking Secured Overnight Financing Rate (SOFR) term rates (SOFR Term Rates) for one-, three- and six-month tenors. This is a major milestone in the transition away from US LIBOR.

This announcement follows completion of the first phase under the SOFR First initiative, which commenced on July 26, 2021 and recommended that financial institutions switch from USD LIBOR to SOFR for all linear swap trades in the interdealer market. That switch boosted overnight SOFR-linked derivatives volumes, which was a market indicator that the ARRC said they would consider in recommending SOFR Term Rates.

Implications and Recommendations

Although SOFR-based rates have not yet been widely adopted in new business loans, the formal recommendation of SOFR Term Rates by the ARRC is expected to boost the switch from USD LIBOR to SOFR Term Rates.

As noted in our previous article on this topic, with the formal recommendation of SOFR Term Rates by the ARRC, legacy contracts that have adopted the ARRC's updated fallback language will, if the relevant SOFR Term Rate tenor exists, fall back to such SOFR Term Rate plus the applicable spread adjustment once the applicable LIBOR replacement date occurs.

For new business loans which incorporate a reference rate, the ARRC recommends using SOFR Term Rates or another SOFR-based rate.

For existing business loans with USD LIBOR exposures, parties should review documentation to determine the extent of the fallback language included therein (if any) and whether any amendments are required

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and/or recommended.

- **No fallback language:** Contracts that do not contain fallback language should be amended to either (a) incorporate the ARRC's recommended "hardwired approach" fallback language or (b) replace USD LIBOR with SOFR Term Rates (plus applicable spread adjustment) or another SOFR-based benchmark replacement.
- **Amendment approach fallback language:** Where contracts contain the ARRC's "amendment approach" fallback language, parties should consider either (a) amending to incorporate the ARRC's recommended "hardwired approach" fallback language or (b) utilizing the amendment process set out therein to replace USD LIBOR with SOFR Term Rates (plus applicable spread adjustment) or another SOFR-based benchmark replacement.
- **Hardwired approach fallback language:** For contracts that contain a form of the ARRC's "hardwired approach" fallback language, USD LIBOR will be automatically replaced with the ARRC-recommended SOFR Term Rates (plus applicable spread adjustment) on the earlier of (a) the cessation of USD LIBOR, (b) USD LIBOR being declared to no longer be representative and (c) an early-opt in election by the relevant parties. Parties should continue to monitor updates in the transition from USD LIBOR to SOFR, and periodically consider whether they want to make an early opt-in election to replace USD LIBOR with SOFR Term Rates (plus applicable spread adjustment) in advance of the cessation of USD LIBOR or USD LIBOR being declared to no longer be representative.

Parties should also review existing documents to determine if the ARRC's recommended SOFR conventions should be incorporated. Please see our previous article on SOFR conventions [here](#).

We will be issuing further articles relating to interest rates. Find other articles in our Interest Rates Watch Series [here](#).

This publication is a general summary of the law. It does not replace legal advice tailored to your specific circumstances.