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Interest Rates Watch: Early Trends in Term SOFR Contracts

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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.

In the early months of 2022, we've continued to see the phase-out of USD LIBOR and an uptick in the number of contracts adopting an alternative reference rate. The adoption of alternative reference rates coincides with the guidance previously provided by Canadian and US regulatory bodies[1] that parties cease using USD LIBOR as a reference rate in new contracts by December 31, 2021.

To date, the market has favoured the replacement rate recommended by the Alternative Reference Rates Committee (ARRC), being the forward-looking Secured Overnight Financing Rate (SOFR) term rate (Term SOFR). Please see our previous article for more information on the ARRC's recommendation of Term SOFR as the USD LIBOR replacement rate. Generally, we've seen three approaches to pricing based on Term SOFR:

1. Term SOFR without a credit spread adjustment (CSA) – reference rate is pegged to Term SOFR without any adjustments;
2. Term SOFR plus a flat CSA – applies a flat CSA (e.g. 10 bps) to each Term SOFR tenor (e.g., one month, three months, and six months) to shift pricing of each tenor by the same amount; and
3. Term SOFR plus a curved CSA – applies a curved CSA, which increases as tenor increases, to account for the fact that the spread differential between historical USD LIBOR averages and Term SOFR is greater as tenor increases.

The credit spread adjustments used in options two and three are intended to bring the resulting reference rate closer to the historical average USD LIBOR rate. Please see our previous article for an analysis of USD LIBOR-SOFR spreads.

To date, the majority of contracts adopting a Term SOFR benchmark rate have utilized Term SOFR plus a curved CSA (option three), which is consistent with the approach in the ARRC's recommended USD LIBOR fallback language. We have also seen market participants employ option one (Term SOFR without a CSA), albeit to a lesser extent than option three. While option two (Term SOFR plus a flat CSA) can be found in the market, this option is used the most infrequently.

In terms of the quantum of the CSAs, many contracts have adopted curved CSAs of 10/15/25 bps for 1

month/3 month/6 month Term SOFR tenors but, of course, CSAs vary. It is worth noting that the 10/15/25 bps CSAs are less than the spread adjustments included in the USD LIBOR hardwired fallback language recommended by the ARRC and adopted in a large number of contracts.[2] Please see our previous article for a discussion on how low interest rates are impacting USD LIBOR-SOFR spread differentials.

Recommendations

As the use of Term SOFR as a reference rate increases, parties should consider which approach to Term SOFR pricing is most suitable for particular contracts/transactions and whether proposed spread adjustments are in line with those in the market. For existing contracts, parties should (1) ensure that such contracts include robust hardwired fallback language and (2) consider whether the Term SOFR pricing approach and spread adjustments in such fallback language are adequate or whether changes are required to bring pricing in line with market practice.

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

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[1] Such regulatory bodies include, in Canada, the Officer of the Superintendent of Financial Institutions and, in the United States, the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

[2] The ARRC hardwired fallback language uses spread adjustments of 11.448 bps for a 1 month Term SOFR tenor, 26.161 bps for a 3 month Term SOFR tenor and 42.826 bps for a 6 month Term SOFR tenor.

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