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Interest Rates Watch: USD LIBOR-SOFR Spreads Move Closer to ARRC Recommended Spreads

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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.

As the transition away from US dollar (USD) LIBOR continues, market participants are continuing to evaluate how the cessation of USD LIBOR, and the recommendation of CME Group's forward-looing Secured Overnight Financing Rate (SOFR) term rates (Term SOFR) as a replacement to USD LIBOR, will impact credit facilities and other arrangements. One important variable which continues to be a focus is the spread adjustment.

Since USD LIBOR is generally higher than Term SOFR, a spread adjustment concept was introduced to make Term SOFR more economically equivalent to USD LIBOR. In setting the recommended spread adjustments, the five-year historical median difference between USD LIBOR and SOFR was used and, as a result, the spread adjustments recommended by the Alternative Reference Rates Committee (the ARRC) were expected to result in Term SOFR rates close to USD LIBOR in "normal" interest rate times.

However, as we noted in our article last fall, as a result of historically low interest rates the spread differentials between USD LIBOR and Term SOFR at that time were significantly less than the spread adjustments recommended by the ARRC. As a result, utilizing the ARRC-recommended spread adjustments (which are incorporated in the ARRC hardwired fallback language) would have resulted in a replacement rate that was higher than it would have been if the real-time USD LIBOR-Term SOFR spot differentials were used. Market participants recognized this disparity and, in many cases, opted to use spread adjustments that were less than the ARRC-recommended spread adjustments.

With interest rates on the rise, however, the USD LIBOR-Term SOFR spot differentials are moving closer to the ARRC-recommended spread adjustments, as seen in the table below.

	1-month	**3-months**	**6-months**
ARRC-recommended spread adjustment	0.11448%	0.26161%	0.42826%
Average September 2021 USD LIBOR-Term SOFR differential[1]	0.031074%	0.065232%	0.095718%

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Average September 2022 USD LIBOR-Term SOFR differential[2]	0.088304%	0.128256%	0.230284%

Sources: https://www.cmegroup.com/market-data/cme-group-benchmark-administration/term-sofr.html and https://www.wsj.com/market-data/bonds

With continued rate hikes expected by the US Federal Reserve, the USD LIBOR-Term SOFR spot differentials are expected to continue to increase.

As USD LIBOR-Term SOFR spot differentials move closer to the ARRC-recommended spread adjustments, we may see parties re-evaluate the spread adjustments utilized in their agreements, particularly those agreements that previously incorporated a lower spread adjustment. Parties may opt to use the ARRC-recommended spread adjustments or a different set of spread adjustments entirely, and may incorporate a transition period to gradually move to selected spread adjustments. Parties may also forgo a spread adjustment, although with rising interest rates creditors will likely be hesitant to adopt this approach without some other economic adjustment (e.g., an increase to the applicable margin).

Parties should consider whether a change to spread adjustments makes sense from a commercial perspective and should ensure that documentation is amended to provide for the desired fallback rate prior to the cessation of USD LIBOR.

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] Average calculated using September 13-17, 2021 rates
[2] Average calculated using September 26-30, 2022 rates