Alternative Reference Rates Committee: *SOFR Starter Kit Part III (also see Part I and Part II)*

SOFR Best Practices

ARRC
ALTERNATIVE REFERENCE RATES COMMITTEE

With LIBOR's end-2021 deadline rapidly approaching, it is important that all market participants are prepared for LIBOR to become unusable. The ARRC has produced numerous tools to assist firms in the transition to SOFR.

The ARRC recently published a set of best practices that outline key recommended milestones that market participants should aim to achieve across floating-rate notes, business loans, consumer loans, securitizations, and derivatives. These best practices are designed to guide you as you transition your institution away from USD LIBOR, providing a clear recommended timeline to help you achieve a seamless transition and ensure that your institution is ready for LIBOR to become unusable.

As described in the best practices, the ARRC recommends that you:

- ✓ **Take active steps to meet the timelines** set out in the recommended transition milestones;
- ✓ **Have clear internal programs in place** to prepare for a transition away from USD LIBOR, including a rigorous assessment of exposures;
- ✓ **Be aware of additional ARRC recommendations** and incorporate additional ARRC recommended conventions into new contracts; and
- ✓ **Have an ongoing dialogue with your key stakeholders** to promote awareness of the transition away from LIBOR and their preparedness for it.

These best practices are grounded in the ARRC's core guidance for preparing for the transition:

1. To the extent not already utilized, new USD LIBOR cash products should include ARRC-recommended, or substantially similar, fallback language as soon as possible.
2. Third-party technology and operations vendors relevant to the transition should complete all necessary enhancements to support SOFR by the end of 2020.
3. New use of USD LIBOR should stop, with timing depending on specific circumstances in each cash product market.
4. For contracts specifying that a party will select a replacement rate at their discretion following a LIBOR transition event, the determining party should disclose their planned selection to relevant parties at least six months prior to the date that a replacement rate would become effective.

Targets for cessation of new use of USD LIBOR:

Sep. 30, 2020	Dec. 31, 2020	Jun. 30, 2021	Sep. 30, 2021
Consumer Loans (Mortgages)	Floating Rate Notes	Business Loans, Derivatives & Securitizations (Other)	Securitizations (CLOs)

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User's Guide to SOFR

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In April 2019, the ARRC published the User's Guide to SOFR – a comprehensive handbook for market participants looking to use SOFR in cash products – along with several ARRC-recommended conventions, including syndicated loans conventions, student loan conventions, cross currency swap conventions, FRN conventions matrix, and a guide on using SOFR in ARMs.

In this practical guide, the ARRC provides four key considerations for you and your organization to think through as you prepare for the transition:

1	Financial products either explicitly or implicitly use some kind of average of SOFR – never a single day's reading of the rate – in determining the floating-rate payments that are to be paid or received. An average of SOFR will accurately reflect movements in interest rates over a given period of time and smooth out any idiosyncratic, day-to-day fluctuations in market rates.
2	Issuers and lenders will face a technical choice between using a simple or compounded average of SOFR as they seek to use SOFR in cash products. A compounded average will more accurately reflect the time value of money, which becomes a more important consideration as interest rates rise, and it can allow for more accurate hedging, which can result in better market functioning. The simple average of SOFR may be operationally easier, and the difference relative to the compounded average of SOFR is typically small even in higher rate environments.
3	Users need to determine the period of time over which the daily SOFRs are observed and averaged. An in advance structure would reference an average SOFR observed before the current interest period begins, while an in arrears structure would reference an average of SOFR over the current interest period.
4	An average of SOFR in arrears will reflect what actually happens to interest rates over the period, but it provides very little notice before payment is due. There have been a number of conventions designed to allow for a longer notice of payment within the in arrears framework – including payment delays, lookbacks, and lockouts – and different markets have successfully adopted each of these.

Note: The User's Guide specifically notes that those who are able to use SOFR should not wait for forward-looking rates in order to transition away from LIBOR.

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Fallback Language

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While the ARRC encourages market participants to write contracts referencing SOFR whenever possible, for those who continue to use USD LIBOR, the ARRC supports the transition to SOFR by publishing recommended fallback language for voluntary use in new USD LIBOR-linked contracts – provisions that specify:

- the trigger events for a transition to a replacement rate;
- the replacement rate itself; and
- the spread adjustment to align the replacement rate with the benchmark being replaced (in this case, USD LIBOR).

The ARRC developed this language for institutions with the goal of avoiding significant market disruption once LIBOR is no longer usable. With the end of LIBOR less than 18 months away, market participants should be incorporating robust fallback language in all new contracts referencing USD LIBOR to help facilitate a smooth transition to alternative reference rates.

The ARRC encourages you to review the recommended contractual fallback language it has published for each of the following products:

- Floating rate notes
- Bilateral business loans
- Syndicated loans
- Securitizations
- Adjustable rate mortgages

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Helpful Tools From the ARRC

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Frequently Asked Questions	Practical Implementation Checklist	Buy-Side / Asset Owner Checklist	Internal Systems / Processes Transition Aid	ARRC Second Report
Syndicated Loan Conventions	Student Loan Conventions	Guide on Using SOFR in ARMs	FRN Conventions Matrix	Cross Currency Swap Conventions