REVERSEinquiries

The ARRC Releases a New Sample Termsheet for the SOFR Index and Follows Up on Its Spread Adjustment Consultation

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On May 6, the Alternative Reference Rates Committee (the "ARRC") published a statement and a sample termsheet on how to use the new SOFR Index with floating rate notes.[1]

The SOFR Index is an alternative to the calculation methods in three previously published ARRC sample termsheets for SOFR floating rate notes.4[2] Under the previous methods, essentially, SOFR (the secured overnight financing rate) was measured each day in the interest period, compounded, and the interest rate for the period was calculated.

The SOFR Index measures SOFR, compounded since April 2, 2018, the first date of publication of SOFR. For a SOFR floating rate note with a base rate of the SOFR Index, the interest rate would be calculated by comparing the SOFR Index levels at the start and end dates of the interest period. The interest period can be of any length. The compounding is reflected in the index level. Just like a structured note linked to the performance of the SPX measured at two points, the result could be a negative or zero interest rate. Consequently, issuers should build in an interest rate floor of zero. The sample termsheet uses a "shifted observation period," wherein the period when interest is measured is a certain number of U.S. Government Securities Business Days prior to the first day of the interest period, and the same number of days prior to the interest payment date.

On the same day, the ARRC released a supplemental consultation on its spread adjustment methodology.[3] The supplemental consultation summarizes feedback received by the ARRC on its original consultation of January 2020, and seeks further input on certain technical details of the spread adjustment. The spread adjustment is designed to be used in the ARRC-recommended fallback provisions for U.S. dollar LIBOR floating rate notes.

These fallback provisions provide that the U.S. dollar LIBOR rate will fall back to SOFR upon a LIBOR cessation. The spread adjustment is designed to minimize value transfer between the U.S. dollar LIBOR rate and SOFR, which are inherently different rates.

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[1] The ARRC's statement on the use of the SOFR Index is available at: https://nyfed.org/2M0VnnV.

[2] We previously discussed the ARRC's three earlier termsheets at: https://bit.ly/2XwcenQ.

[3] The supplemental consultation is available at: https://nyfed.org/2ZJw7KH.