

April 9, 2020

## **LIBOR Cessation: ARRC Announces Recommendation for Spread Adjustment Methodology for Cash Products**

On April 8, 2020, the Alternative Reference Rate Committee (“ARRC”), a working group convened to help prepare for the cessation of the U.S. dollar London Interbank Offered Rate (USD LIBOR), announced that it had agreed on a recommended spread adjustment methodology for cash products referencing USD LIBOR.<sup>1</sup> The ARRC has previously endorsed the Secured Overnight Financing Rate (“SOFR”) as its recommended alternative to USD LIBOR following the anticipated cessation of LIBOR at the end of calendar year 2021<sup>2</sup> and has developed recommended fallback language to facilitate the transition away from LIBOR for inclusion in various cash products referencing LIBOR.<sup>3</sup> In order to “minimize the expected change in the value of contracts as a result of shifting from USD LIBOR to SOFR,” the ARRC has proposed that a static spread be added to SOFR when included in legacy contracts as the new replacement rate, so that the spread-adjusted SOFR would be comparable to USD LIBOR.<sup>4</sup>

The ARRC now recommends that the methodology for determining the spread adjustment be “based on a historical median over a five-year lookback period calculating the difference between USD LIBOR and SOFR.”<sup>5</sup> This is the same spread adjustment methodology previously recommended by the International Swaps and Derivatives Association (“ISDA”) for derivatives transactions and would therefore align the recommended spread-adjusted version of SOFR used in both the cash and derivatives markets.<sup>6</sup> Consistent adjustment methodologies across cash and derivatives products further would reduce basis risk and alleviate legal, operational and accounting concerns regarding differences between financing products and related hedging positions.

The ARRC’s recommendation is based on its solicitation of feedback from market participants through a public consultation, which resulted in more than 60 responses from consumer advocacy groups, asset

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<sup>1</sup> *ARRC Announces Recommendation of a Spread Adjustment Methodology for Cash Products*, available [here](#).

<sup>2</sup> *The ARRC Selects a Broad Repo Rate as its Preferred Alternative Reference Rate*, available [here](#).

<sup>3</sup> An overview of recommended fallback language for various contracts is available [here](#).

<sup>4</sup> *ARRC Releases Consultation on Potential Spread Adjustment Methodologies*, available [here](#).

<sup>5</sup> *ARRC Announces Recommendation of a Spread Adjustment Methodology for Cash Products*, available [here](#). Note that for consumer products, the ARRC recommends a one-year transition period to this spread adjustment methodology.

<sup>6</sup> *Id.*

managers, corporations, banks, industry associations, government-sponsored entities, and others.<sup>7</sup> Almost all of the respondents favored adoption of ISDA's methodology of a five-year median of the historical difference between LIBOR and SOFR.<sup>8</sup> Respondents emphasized the importance of consistency across products, currencies, fallback triggers, and spread adjustments, and focused in particular on the importance of aligning the cash and derivatives markets to reduce basis risk between cash products and their related hedges.<sup>9</sup>

The ARRC has announced that it will release additional details regarding its recommended spread adjustment methodology in the coming weeks.<sup>10</sup>

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Mark S. Bergman  
+44-20-7367-1601

[mbergman@paulweiss.com](mailto:mbergman@paulweiss.com)

H. Christopher Boehning  
+1-212-373-3061

[cboehning@paulweiss.com](mailto:cboehning@paulweiss.com)

Susanna M. Buerger  
+1-212-373-3553

[sbuerger@paulweiss.com](mailto:sbuerger@paulweiss.com)

Jessica S. Carey  
+1-212-373-3566

[jcarey@paulweiss.com](mailto:jcarey@paulweiss.com)

Manuel S. Frey  
+1-212-223-3127

[mfrey@paulweiss.com](mailto:mfrey@paulweiss.com)

Brad S. Karp  
+1-212-373-3316

[bkarp@paulweiss.com](mailto:bkarp@paulweiss.com)

Jane B. O'Brien  
+1-202-223-7327

[jobrien@paulweiss.com](mailto:jobrien@paulweiss.com)

Richard A. Rosen  
+1-212-373-3305

[rrosen@paulweiss.com](mailto:rrosen@paulweiss.com)

Charles F. "Rick" Rule  
+1-202-223-7320

[rrule@paulweiss.com](mailto:rrule@paulweiss.com)

Amy L. Barton  
+1-212-373-3285

[abarton@paulweiss.com](mailto:abarton@paulweiss.com)

*Associate Hilary Christian contributed to this client memo.*

<sup>7</sup> *Id.*

<sup>8</sup> *Responses to the ARRC Consultation on Spread Adjustment Methodologies for Fallbacks in Cash Products Referencing USD LIBOR*, available [here](#).

<sup>9</sup> *Id.*

<sup>10</sup> *ARRC Announces Recommendation of a Spread Adjustment Methodology for Cash Products*, available [here](#).