FHN FINANCIAL
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WEEKLY COMMENTS

Adjustable Rate Mortgages: The Change From LIBOR to SOFR

The London Interbank Offering Rate (LIBOR) is scheduled to be replaced as a market index at the end of 2021. This will have an impact on all financial institutions that originate adjustable rate mortgages (ARMs) as well as other loan types, securities, and swaps. If you haven't already started to prepare, now is the time to start analyzing your options as the deadline approaches.

Overview

You've likely heard about LIBOR being eliminated as an index for lenders. It has been discussed on TV, in articles, and at conferences for the past several years. While some market players have hoped that LIBOR's demise would get delayed or scrapped, the end of 2021 is still the expected date that financial institutions will no longer be required to submit rates that comprise the index. The end of LIBOR has always seemed to be far off, but it is now clearly in front of us, and institutions should begin to focus on making changes if they haven't already.

Much of the work being done in the industry has focused on finding a suitable replacement for LIBOR. The index that has begun trading is called SOFR, Secured Overnight Financing Rate. These efforts to replace LIBOR with SOFR are being led by the Alternative Reference Rate Committee (ARRC), a group made up of a variety of market participants that was convened by the Federal Reserve Board and the New York Fed. For institutions active in originating residential mortgages, you've likely noticed that Fannie Mae and Freddie Mac have issued securities tied to the SOFR index.

Impact on Residential Mortgages

There have already been some impacts of LIBOR's end to the residential mortgage market. In May 2019, the FHFA issued guidance that LIBOR indexed loans could no longer be sold or securitized with Fannie Mae or Freddie Mac if they were seasoned greater than six months. This effectively eliminated the seasoned bulk market for conforming, adjustable-rate loans tied to LIBOR. For now, LIBOR loans seasoned less than six months remain agency eligible.

There hasn't been a direct impact yet on jumbo mortgages tied to LIBOR, though market liquidity has tightened somewhat. At this point, that liquidity change may have more to do with the current interest rate environment than LIBOR.

What to do Next

With the LIBOR changes on the horizon, there are a couple of things your institution should consider for action on your residential mortgages in the near future.

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- **Review trigger and "fall-back" language** — Your standard mortgage documents for adjustable rate loans should include language that addresses the event of a change in reference index. For some, this may be an alternate index that is pre-defined. For others, it may give the lender some leeway to determine an appropriate replacement index. Click here for ARRC recommended fallback language for ARMs.
- **Consider changing reference index for new originations to SOFR** — While there have been some volatility hiccups in trading of SOFR, especially at quarter-end, it wasn't as much of an issue in December as it was in September 2019. Participants are expected to be able to choose between either a simple or compound interest index, both of which are expected to be published. This reviews SOFR options associated with ARMs.

  On February 5, the Federal Housing Finance Agency (FHFA) issued guidance related to the transition away from LIBOR. Part of this announcement included the possible ineligibility for sale of CMT-indexed ARMs to Fannie Mae and Freddie Mac starting in 2021, a specific date to be determined later. While it looks like CMT ARMs will be eligible for a year or more, a transition from LIBOR to CMT looks like it would be a very short-term solution at best and originators should focus efforts on preparing for SOFR-indexed ARMs. Links to both Fannie Mae and Freddie Mac Single-Family LIBOR Transition Announcements are below.

You will continue to hear more and more about the elimination of LIBOR and the evolution of SOFR. FHN Financial Capital Assets Corp. (Capital Assets) will try to help keep you abreast of changes and how they will impact your institution. In the meantime, if you'd like more information about AARC, click on the link below. If you have any questions or would like an analysis of your mortgage loans, please contact your FHN Finncial account rep or Capital Assets directly at 800.456.5460.

Alternative Reference Rate Committee

LIBOR TRANSITION ANNOUNCEMENTS FROM FANNIE MAE AND FREDDIE MAC:

https://singlefamily.fanniemae.com/media/document/pdf/lender-letter-ll-2020-01

https://guide.freddiemac.com/app/guide/bulletin/2020-1