

Federal Housing Finance Agency  
Office of Inspector General



# **Enterprises' Transition from LIBOR to an Alternative Index for Single-Family ARMs**

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## Executive Summary

The London Interbank Offered Rate (LIBOR) reflects the cost at which large banks can borrow on an unsecured basis in wholesale financial markets and is the most widely used interest rate benchmark in the world. In July 2017, due to concerns about LIBOR's sustainability, the United Kingdom's Financial Conduct Authority, the regulator of LIBOR, announced LIBOR would not be supported past 2021. That same year, the Alternative Reference Rates Committee (ARRC) identified the Secured Overnight Financing Rate (SOFR) as its preferred alternative reference rate in the United States. Although LIBOR is utilized in multiple aspects of the Enterprises' business, this white paper focuses on the transition away from LIBOR in the Enterprises' single-family adjustable-rate mortgages (ARMs).

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## ABBREVIATIONS .....

ARM	Adjustable-rate mortgage
ARRC	Alternative Reference Rates Committee
Enterprises	Fannie Mae and Freddie Mac
FHFA or Agency	Federal Housing Finance Agency
LIBOR	London Interbank Offered Rate
OIG	Federal Housing Finance Agency Office of Inspector General
SOFR	Secured Overnight Financing Rate

## BACKGROUND.....

LIBOR reflects the cost at which large banks can borrow on an unsecured basis in wholesale financial markets and is the most widely used interest rate benchmark in the world. In July 2017, due to concerns about LIBOR’s sustainability, the United Kingdom’s Financial Conduct Authority, the regulator of LIBOR, announced LIBOR would not be supported past 2021. That same year, the ARRC identified SOFR as its preferred alternative reference rate in the United States.

As of September 2019, the vast majority—over 80 percent—of each Enterprise’s current single-family ARM portfolio was indexed to LIBOR. An ARM is a mortgage with an interest rate that adjusts periodically over the lifetime of the loan.<sup>1</sup> The terms of that adjustment in interest rate are set in the mortgage note.<sup>2</sup> ARM interest rates are set by the index and the margin. The index is a variable market interest rate, such as LIBOR, to which the ARM is tied.<sup>3</sup>

### Enterprises Identify LIBOR Transition as a Risk

Enterprise ARM notes contain fallback language that permits the Enterprises to “choose a new index that is based upon comparable information” in the event “the Index is no longer available.” Both Enterprises recognize the discontinuation of LIBOR is a top risk in their respective 10-Ks and internal documents. That risk has two components. First, the Enterprises must offer a new ARM product indexed to an alternative reference rate. Second, they must transition LIBOR-indexed ARMs already on their books (legacy ARMs) to an alternative reference rate.

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<sup>1</sup> For more information on Enterprise ARMs, see *OIG, Fannie Mae and Freddie Mac Purchases of Adjustable-Rate Mortgages* (Jan. 4, 2018) (WPR-2018-001) (online at [www.fhfa.ig.gov/sites/default/files/WPR-2018-001.pdf](http://www.fhfa.ig.gov/sites/default/files/WPR-2018-001.pdf)).

<sup>2</sup> ARMs have an initial period—usually between six months and ten years—during which the interest rate and payment do not change, followed by periods of variable rates and payments until the loan is paid off.

<sup>3</sup> The margin is an additional rate, usually constant, that the lender adds above the index.

## TRANSITION FROM LIBOR .....

### Recommendation of a New Reference Rate to Replace LIBOR by the ARRC

The ARRC was convened in 2014 by the Federal Reserve Board and the Federal Reserve Bank of New York to identify a new reference rate to replace LIBOR. The ARRC was tasked with identifying a new risk-free or nearly risk-free rate (based on transactions from a strong, liquid underlying market), in compliance with international best practices for financial benchmarks. At that time, the ARRC was composed of private financial market participants and various ex officio and non-voting financial regulator members.<sup>4</sup>

In June 2017, the ARRC announced its recommendation that SOFR be adopted as the alternative reference rate to LIBOR.<sup>5</sup> SOFR is a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities. SOFR is a rate produced by the Federal Reserve Bank of New York based on observable transactions rather than estimates.<sup>6</sup> According to the ARRC, SOFR should remain available in a wide range of market conditions due to the strength of its underlying market.

#### *The ARRC's Considerations on Use of SOFR for ARMs*

The ARRC was reconstituted in March 2018 to expand its membership to a broader set of market participants to help ensure successful implementation of SOFR as an alternative reference rate. The Enterprises became members of the reconstituted ARRC and FHFA became an ex officio and non-voting member, which gave them direct involvement in the ARRC's transition work for ARMs.

The ARRC has published white papers and reports focusing on the transition for different categories of financial products utilizing LIBOR to alternative reference rates. One focus of

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<sup>4</sup> In November 2016, the ARRC formed an advisory group that included the Enterprises as members. The advisory group provided input to the recommendations for a new reference rate and transition strategy, called the Paced Transition Plan.

<sup>5</sup> SOFR is quoted in various ways. The Federal Reserve Bank of New York began publication of 30-, 90-, and 180-day SOFR averages as well as a SOFR Index on March 2, 2020. On January 21, 2020, the ARRC released a consultation proposing a static spread adjustment that would make a spread-adjusted version of SOFR comparable to LIBOR. This spread-adjusted SOFR adjusts SOFR to minimize the expected change in the value of contracts, such as ARMs, as a result of shifting from LIBOR to SOFR.

<sup>6</sup> LIBOR is calculated and published daily across five currencies and seven maturities by the Intercontinental Exchange Benchmark Administration based on submissions from panel banks. The volume of unsecured wholesale lending has dwindled significantly requiring the panel banks to submit estimates based on expert judgment rather than actual market activity.

the ARRC’s efforts has been discussion of SOFR as an alternative reference rate for ARMs. The ARRC issued a white paper in July 2019 on the differences between SOFR and LIBOR, recommendations to use an averaged version of SOFR to smooth out day-to-day fluctuations and adjustments to the rate reset to better balance borrower and investor interests, and possible challenges and benefits to consumers from use of SOFR as the alternative reference rate for ARMs.<sup>7</sup>

As discussed previously, current ARM contract language used by the Enterprises allows a noteholder to “choose a new index that is based upon comparable information” if the original index becomes unavailable. However, that language does not elaborate on the terms of comparability nor does it explain what might “trigger” index unavailability. To provide greater clarity, the ARRC issued recommended revised fallback language for ARMs in November 2019.

### **FHFA’s Transition Guidance to the Enterprises**

FHFA, as conservator, authorized the Enterprises in August 2018 to engage in joint discussions about ARRC projects. In December 2018, FHFA established an internal Reference Rate Transition Steering Committee to facilitate the Enterprises’ ability to transition from LIBOR to more robust reference rates, with a goal of managing the transition in a timely and safe and sound manner, including mitigating the associated risks.

FHFA’s 2019 conservatorship scorecard required the Enterprises to prepare for the transition from LIBOR. By early 2019 the Enterprises were focusing on SOFR as an alternative reference rate to LIBOR for new ARMs. According to internal FHFA documents, the Enterprises provided FHFA inventories of their technologies and processes affected by the LIBOR transition for ARMs and transition roadmaps with key milestones to achieve ARM transition readiness.

In its 2020 scorecard, FHFA instructed the Enterprises to “prepare for an effective transition from LIBOR to approved alternative reference rates.” Additional guidance from FHFA set expectations for the Enterprises to introduce new SOFR-based ARMs in the fourth quarter of 2020, if feasible. The Agency also described expectations for lender, investor, service provider, and consumer communication tools related to the LIBOR transition for ARMs and required the Enterprises to submit regular updates to the FHFA Reference Rate Transition Steering Committee.

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<sup>7</sup> See The Alternative Reference Rates Committee, *Options for Using SOFR in Adjustable Rate Mortgages* (July 2019) (online at [www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-SOFR-indexed-ARM-Whitepaper.pdf](http://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-SOFR-indexed-ARM-Whitepaper.pdf)).

## Transition to a New SOFR-based ARM Product from a LIBOR-based ARM Product

An FHFA official explained to us that the Agency's priority for the Enterprises has been the development of a new SOFR-based ARM product to ensure that this ARM product would be viable when LIBOR fails. A Freddie Mac official advised that it is important to quickly create a new ARM product to help the industry transition from LIBOR ARM originations.

On February 5, 2020, the Enterprises announced that they will purchase SOFR ARMs that have fixed rates for three, five, seven or ten years, with six-month resets afterward, subject to maximum changes at each reset and a maximum increase over the life of the loan. This announcement included key features of their new ARM plans that track the recommendations in the ARRC white paper. The Enterprises anticipate being able to accept delivery of SOFR ARMs during the second half of 2020. The announcement also explained that the Enterprises will not purchase LIBOR ARMs with an application date after September 30, 2020, and will no longer purchase any LIBOR ARMs after December 31, 2020. This transition period provides lenders time to clear their origination pipelines. It also explained that, effective June 1, 2020, lenders must use updated ARM notes that include the fallback language recommended by the ARRC. This February 5, 2020, announcement advised that additional details about the SOFR ARMs would be released in the coming months, including application start dates and eligibility, underwriting, and pricing requirements.

FHFA directed the Enterprises to submit Enterprise-wide implementation plans during the first quarter of 2020. According to FHFA, these implementation plans will direct the publication of the transition guidance that will detail how the Enterprises will cease LIBOR-based ARM purchases and begin SOFR-based ARM purchases. Transition information for lenders, investors, servicers, and borrowers is scheduled to be released in the coming months.

### ***Risk Considerations***

According to a Fannie Mae official, the risk involved in launching a new SOFR-based ARM product is comparable to the operational and market risk involved in launching other new products. The official explained that Fannie Mae routinely launches new products based on well-developed processes, and Fannie Mae could face the standard operational risks associated with new product launches, including the risk that the market might not adopt the new product. A Freddie Mac official noted there could also be technology-based risk as the Enterprises or their seller/servicers develop or change systems to accommodate new processes required by the new product. A Fannie Mae official suggested the risks could be mitigated through proper servicing and consumer education.

There is also risk involved in finding the correct timing to cease purchasing LIBOR-based ARMs. An FHFA official told us that if the Enterprises stop purchasing LIBOR-based ARMs



too soon, the ARM market could collapse. Another FHFA official estimated that it takes roughly a year to launch a new product, explaining that lenders typically need six to twelve months to prepare to get a new product into the marketplace, and the Enterprises have to update their respective automated underwriting systems. Subsequent to our interview, as noted above, the Enterprises announced that they will no longer purchase LIBOR ARMs after December 31, 2020. Although that is slightly shorter than the one-year launch period estimated by the FHFA official, it is still well ahead of the announced cessation of LIBOR support on December 31, 2021.

### **Transition for Enterprise Legacy LIBOR ARMs**

According to an FHFA official, the Agency will address transitioning legacy ARMs after the new SOFR-based ARM products are established. The Enterprises have transitioned indexes on existing ARMs before, but Enterprise officials explained to us that these prior instances were extremely limited in scope and did not provide substantive experience on an analogous scale to guide them through the current LIBOR transition.

Until LIBOR actually becomes “unavailable,” existing LIBOR-based ARMs cannot be transitioned to a new reference rate according to a Fannie Mae official. The official told us that analytics can be done in advance and system and governance preparation can occur to be ready once LIBOR becomes unavailable and a transition of legacy ARMs is required. Similarly, a Freddie Mac official told us that preparation can occur in advance. Officials from both Enterprises indicated that the new rate does not necessarily have to be known to prepare technology system for how to process the new rate, and those officials told us they are working to update their technology to accommodate the transition. The Enterprises are also engaging with their seller/servicers to determine how the transition will impact them. They are working with the ARRC to develop a SOFR-based index that compares to LIBOR.<sup>8</sup>

Once the Enterprises determine LIBOR is no longer available, they will have to designate a specific successor index to their servicers for implementation. A Fannie Mae official estimated seller/servicers may need six to twelve months to update their systems to accommodate the replacement rate. According to a Freddie Mac official, the servicers will provide the required notice to borrowers and implement the consumer-facing changes.

As with new ARMs, internal FHFA guidance to the Enterprises prioritizes communication to lenders, investors, servicers, and consumers to prepare for an “effective transition” to an alternative reference rate. An FHFA official told us that the FHFA Director has made

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<sup>8</sup> The ARRC is currently in a consultation period soliciting comments on the creation of a SOFR-based index that incorporates a spread adjustment to minimize changes in value compared to LIBOR.

consumer outreach a priority. Internal FHFA guidance notes that the Enterprises' publication of the guidance and FAQs will aid in preparation for the transition.

### ***Risk Considerations***

FHFA assessed that the LIBOR transition for legacy ARMs may present a material risk to the Enterprises, which may include financial, operational, legal, regulatory, technology, and other risks. By contrast to new originations, the transition for legacy ARMs requires making changes related to existing loans, including providing notice to borrowers of the replacement index, which includes operational risk. Also, the risks associated with the new originations transition are smaller because, according to a Freddie Mac official, there are relatively few new ARM acquisitions. An FHFA official explained to us that the transition may also present reputational risk. A Fannie Mae official told us that the legal risk tied to the transition for legacy ARMs from LIBOR to an alternative rate presents the greatest and most concerning risk compared to the risks related to new SOFR ARMs. Freddie Mac told us that although the transition for legacy ARMs presents potentially more significant legal risks than the transition to new SOFR ARMs, the Enterprise does not view one as having greater risk than the other.

According to Fannie Mae officials, Enterprise collaboration in preparation for the transition, as well as their participation in the ARRC, may help mitigate risks involved in transitioning legacy ARMs to a new replacement index. The ARRC has provided a forum for various entities to work together to resolve the complicated issues presented by the LIBOR transition. One Enterprise stated the inclusion of such a wide selection of expertise should aid the ARRC in ensuring a fair and orderly transition for legacy ARMs. FHFA, Fannie Mae, and Freddie Mac officials all highlighted the importance of what they viewed as the ARRC's transparent process.

## **CONCLUSION.....**

Both Enterprises recognize that discontinuation of LIBOR is a top risk. That risk has two components for their single-family ARMs. First, the Enterprises must offer a new ARM product indexed to an alternative reference rate. Second, they must transition legacy ARMs to an alternative reference rate. This white paper summarizes those transitions and the associated risk considerations.

## OBJECTIVE, SCOPE, AND METHODOLOGY .....

The objective of this white paper was to provide background information on the Enterprises’ transition from LIBOR to an alternative index for single-family ARMs. To achieve this objective, we reviewed internal FHFA, Fannie Mae, and Freddie Mac documents as well as publicly available documents. We also interviewed FHFA, Fannie Mae, and Freddie Mac officials.

We provided FHFA with the opportunity to respond to a draft of this white paper. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of this white paper.

## ADDITIONAL INFORMATION AND COPIES.....

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