Recent Developments on the LIBOR/SOFR Transition

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As the proposed cessation of London Inter-Bank Offered Rate (LIBOR) on December 31, 2021 draws closer, market participants have been making progress on several initiatives to create a smooth transition to alternative reference rates like the **Secured Overnight Financing Rate (SOFR)**. There have been recent developments that occurred early in 2020 that we would like to summarize for FHLBank Boston members in an effort to help you understand the potential impact each action could have.

Fannie, Freddie to Stop Accepting LIBOR Mortgages

New York Fed to Publish SOFR Averages & SOFR Index

LIBOR Cessation Planning: A Supervisory Priority for Credit Unions

Fixed Income and Derivatives Markets Usage of SOFR Continues to Grow

LIBOR's sunset is fast approaching, and while headway has been made to address legal, financial, and operational risks in the transition, there is still more work to be done. Uncertainty with the successful outcome of certain solutions exists, so the best course of action for financial institutions is to be proactive and thorough in how they are working through the LIBOR/SOFR transition.

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You can also reach out to your relationship manager.

Fannie, Freddie to Stop Accepting LIBOR Mortgages

What happened:

- On February 5, Fannie Mae and Freddie Mac announced they will no longer accept mortgage loans tied to LIBOR after December 31, 2020.
- In the second half of 2020, the agencies are anticipating that loans referencing SOFR will become eligible for delivery.
- They also indicated that at some point in 2021 they will cease purchasing loans that use a Constant Maturity Treasury (CMT) index.

What the implications are:

- With a secondary market outlet for SOFR loans, originators may now have more support to expand their product lineup.
- Without Fannie and Freddie providing demand, the liquidity profile for LIBOR loans may weaken.
- Market gets closer to seeing SOFR-based residential Mortgage-Backed Securities (MBS), providing banks, credit unions, and insurance companies an option for a high-credit quality, cash-flow producing floating-rate asset.

New York Fed to Publish SOFR Averages & SOFR Index

What happened:

- On February 12, the Federal Reserve Bank of New York (New York Fed) announced that on March 2 they will begin publishing 30-, 90- and 180-day SOFR Averages, as well as a SOFR Index.

What the implications are:

- New York Fed received considerable support for the publication of SOFR Averages and a SOFR Index.
- Greater visibility into the calculation of SOFR across a range of time periods supports the adoption of the index as a replacement to LIBOR.
- Progress continues to be made on the development of a forward-looking term structure for SOFR (for example, one-month or three-month SOFR, as opposed to the overnight index).

LIBOR Cessation Planning: A Supervisory Priority for Credit Unions

What happened:

- In January, the National Credit Union Administration (NCUA) released supervisory priorities which included a focus on how credit unions are planning for the end of LIBOR.

What the implications are:

- Making sure all aspects of LIBOR exposure are identified, compliant, regulated and understood will be key for the NCUA during the LIBOR transition.
- Banking regulators are focusing on the LIBOR transition as well; In the Semiannual Risk Perspective for Fall 2019, the Office of the Comptroller of the Currency (OCC) highlighted the 2021 end date for LIBOR and noted that "the OCC is increasing regulatory oversight of this area to evaluate bank awareness and preparedness."

Fixed Income and Derivatives Markets Usage of SOFR Continues to Grow

What happened:

- Global issuance of SOFR-referenced debt has exceeded $250 billion, with the Federal Home Loan Bank system accounting for more than 50% of that amount.
- Large multinational banks have been accelerating the issuance of SOFR debt and community banks have issued subordinated debt issues with fixed to floating structures, using SOFR as the reference index for the variable-rate period.
- The U.S. Treasury has requested information from market participants to gauge interest in a floating-rate note referencing SOFR.
- SOFR options began trading and futures activity and participation continues to increase.

What the implications are:

- As the cash and derivatives markets for SOFR keep evolving and growing, participants of all shapes, sizes and business models can prudently reduce their exposure to LIBOR, while still meeting the ongoing asset and liability management needs of their balance sheet.
- The growth in the market for SOFR-related corporate debt is a positive development for investors like insurance companies who rely heavily on corporate bonds in their investment portfolio.
- The use of SOFR in subordinated debt issuance affords community banks the ability to optimize their capital structure with their targeted interest rate exposure.
- A SOFR-linked Treasury note could have a significant positive impact, spurring derivatives activity and serving as a benchmark for other debt issuers.
- Increasing market adoption has allowed FHLBank Boston to develop new products such as the SOFR-Indexed Advance, as well as work towards reintroducing popular advance solutions like the Flipper Advance, without any reliance on LIBOR.