July 11, 2019

ARRC Releases White Paper on Using an Average of SOFR to Build an Adjustable-Rate Mortgage Product for Consumers

The Alternative Reference Rates Committee (ARRC) today released a white paper detailing how an average of the Secured Overnight Financing Rate (SOFR) can be used in newly issued adjustable-rate mortgages (ARMs) in a structure that is comparable to today's existing ARM loans.

The white paper was developed by the ARRC's Consumer Products Working Group and is the first to show how SOFR can be used to provide a more robust reference rate for consumer loans.

"The white paper we are releasing today demonstrates how SOFR can be used to benefit consumers. The paper shows that there are ways to avoid subjecting consumers to the risks inherent in LIBOR. It is possible to use SOFR now to develop products that are built on a robust reference rate that is firmly grounded in market transactions," said Tom Wipf, ARRC Chair and Vice Chairman of Institutional Securities at Morgan Stanley.

The white paper demonstrates that basing an ARM loan on an average of SOFR can provide consumers with a stable rate that would be consistent with other competitive rates on existing loan products. The SOFR-indexed ARM concept would provide consumers with certainty when payments reset by referencing an average of SOFR calculated prior to the reset date. The reset frequency would be set at six months to mitigate any potential mismatch between the loan rate consumers pay and changes in market interest rates related to expectations of future changes in economic conditions, and rate caps would be adjusted accordingly.

The Working Group actively engaged with consumer groups, lenders, investors, and service providers, including Fannie Mae and Freddie Mac, in discussing the many considerations laid out in this paper.

In separate statements, Fannie Mae and Freddie Mac indicated support for the ARRC's recommendation to replace the LIBOR index with a new index based on SOFR. The Enterprises will work closely with the ARRC, the Federal Housing Finance Agency, and other industry participants on a thoughtful and deliberate process to implement this recommendation within the home mortgage lending industry by the end of 2021.

A one-page summary of the SOFR ARM white paper can be found here.

Separately, the ARRC intends to issue a consultation on fallback contract language for consumer mortgages on July 12.

About the ARRC

The ARRC is a group of private-market participants convened by the Federal Reserve Board and Federal Reserve Bank of New York in cooperation with the Consumer Financial Protection Bureau, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Office of Financial Research, the Office of the Comptroller of the Currency, the Commodity Futures Trading Commission, the Securities and Exchange Commission and the U.S. Treasury Department. It was initially convened in 2014 to identify risk-free alternative reference rates for USD LIBOR, identify best practices for contract robustness, and create an implementation plan with metrics of success and a timeline to support an orderly adoption. The ARRC accomplished its first set of objectives and identified SOFR as the rate that represents best practice for use in certain new USD derivatives and other financial contracts. It also published its Paced Transition Plan, with specific steps and timelines designed to encourage adoption of SOFR. The ARRC was reconstituted in 2018 with an expanded membership to help to ensure the successful implementation of the Paced Transition Plan, address the increased risk that LIBOR may not exist beyond 2021, and serve as a forum to coordinate and track planning across cash and derivatives products and market participants currently using USD LIBOR.

Sign up here to receive email updates about the ARRC.

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