VEGA ECONOMICS

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MBS and the LIBOR Transition: Risk Disclosures of Newly Issued MBS Backed by SOFR-Indexed Loans

As part of the industry transition to a new reference rate for adjustable rate mortgages, Fannie Mae has issued the market's first mortgage-backed securities (MBS) backed by adjustable-rate mortgages (ARMs) referencing the Secured Overnight Financing Rate (SOFR). This demonstrates Fannie's operational readiness to advance the transition from the London Interbank Offered Rate (LIBOR) to an alternative reference rate, and may signify further market acceptance of SOFR as the alternative reference rate. The loans backing these certificates accrue interest based on the "30-day average SOFR," which refers to the compounded average SOFR over a rolling 30-calendar day period as published on the FRBNY's website on the applicable index determinate date.

Vega Economics, in staying at the forefront in helping our clients prepare for the issues involved with the LIBOR transition, has analyzed the available deal documents for these new MBS and identified the disclosures and terms involving the use or reliance of the SOFR index. Deal documents for MBS generally contain information about the tranches in the MBS, cash flow structures, credit enhancements, yield of the tranches under different prepayment speeds, risk factors, and other items such as tax treatment. Our analysis of the deal documents has revealed that they include a great deal of disclosure regarding the uncertainties surrounding the use of SOFR index. These disclosures include those related to SOFR not being well established, fallback provisions for if SOFR is unavailable, and collateral reliance on SOFR, among others.

RISK DISCLOSURES

- SOFR is a relatively new interest rate index, and it is not certain that it will become widely established in lending markets, which may affect the liquidity and create increased pricing volatility and market risk. Investors may be unable to sell their certificates or sell them at prices that provide yields comparable to those of similar investments with a more developed secondary market.
- SOFR may experience higher levels of volatility relative to other interest rate benchmarks. There can be no guarantee that SOFR will not be discontinued or fundamentally altered in a manner that could be materially adverse to the interests of investors in the certificates. The method for determining SOFR, including any market accepted adjustments, may change over time. The FRBNY may alter the methods of calculation, publication schedule, rate revision practices or availability of SOFR at any time without notice.
- There is no mechanism for the SOFR loans to covert to a different index rate if there is a change to the manner in which SOFR is calculated or if a different interest rate benchmark emerges as the prevailing industry practice (in the absence of a transition event).

FALLBACK PROVISIONS

- Index rate transition events include public statements or publication of information by certain parties that SOFR will no longer be provided or is no longer representative of underlying market or economic conditions.
- The index replacement will be determined by Fannie and is equal to the sum of (a) the alternate rate of interest and (b) an index replacement adjustment. If the index replacement is less than zero, the index replacement will be deemed to be zero.
- Fannie makes the following disclaimers are make about a potential replacement index: (1) no assurance that any index replacement will be sufficient to produce the economic equivalent of SOFR; (2) constraints may preclude the adoption of a replacement index in a manner consistent with market consensus or investor expectations; and (3) the systems and procedures necessary to adopt a specific index replacement may delay and contribute to uncertainty and volatility surrounding any index transition.

REPLACEMENT TERMS

- Fannie will select an index replacement and it will replace the then-current index for all purposes relating to the certificates.
- Fannie reserves the right to make technical, administrative, or operational change appropriate to reflect the adoption and implementation of an index.
- Fannie's decisions and determinations are conclusive binding absent manifest errors.