

Agency SOFR Cap Update

Freddie and Fannie kicked off their transition from LIBOR to SOFR floating rate products in late Q3 2020. With many multifamily borrowers beginning to close on their first SOFR based loans, we wanted to address some of the frequently asked questions and provide an update with where things stood on Agency SOFR caps. Per the Freddie and Fannie websites, these are the critical transition dates:

September 1

- Freddie - all new floating-rate quotes and SBL hybrid applications will be for SOFR-indexed loans only
- Fannie - begin quoting SOFR-indexed SARM, ARM 5-5, ARM 7-6 and the Hybrid ARM

September 30

- Freddie and Fannie - last day to go **under app** for LIBOR-indexed floating-rate loans

October 1

- Fannie - all ARM quotes and applications will be SOFR-indexed

November 9*

- Freddie - last day to **submit underwriting packages** for LIBOR-indexed floating-rate loans and SBL hybrids

December 11*

- Freddie - last day to **submit final delivery packages** for LIBOR-indexed floating-rate loans and SBL hybrids

December 31

- Freddie and Fannie - final purchase date for LIBOR-indexed ARMs, regardless of the loan application or note dates

*this is an outside date and specific LIBOR loans may be subject to earlier deadlines.

LIBOR vs. SOFR – Cap Economics

The switch to SOFR doesn't change much as far as the economics of the underlying interest rate cap. Freddie and Fannie selected NY Fed 30D SOFR as the replacement index, and aside from a couple tweaks to the language, everything pretty much looks and feels the same.

Index – [BBA USD LIBOR \(1 month\)](#)

Accruals – from and including the 1st calendar day of each month to but excluding the 1st calendar day of the following month

Payments – paid on the 1st calendar day of the next Accrual period

Resets – 1st day of each Accrual period with a one (1) [London](#) banking day lookback on resets

Index – [NY FED 30D SOFR](#)

Accruals – from and including the 1st calendar day of each month to but excluding the 1st calendar day of the following month

Payments – paid on the 1st calendar day of the next Accrual period

Resets – 1st day of each Accrual period with a one (1) [New York](#) banking day lookback on resets

SOFR cap providers and execution

Currently there are only a handful of banks set up to sell caps based on SOFR. Of those, only two are Freddie approved and one Fannie approved. Thus far, the transition has been very smooth and there are no notable changes to the onboarding and execution process.

Below we've included a list of Agency approved cap providers and our understanding of their timelines to get up and running.

Bank	LIBOR Caps		SOFR Caps	
	Freddie	Fannie	Freddie	Fannie
SMBC	Yes	Yes	Yes	Yes
CBA	Yes	No	Q4 2020	TBD
US Bank	Yes	N/A	Yes	N/A
Wells Fargo	Yes	Yes	Early 2021	Early 2021
BoNY	Yes	No	TBD	TBD
RBC	Yes	Yes	Q4 2020	Q4 2020
Barclays	Yes	N/A	TBD	N/A

Premiums for SOFR caps

The only notable difference when comparing LIBOR and SOFR hedges is a slight premium for the latter index.

Due to thin market liquidity, many traders are hedging SOFR based caps using the same Eurodollar futures contracts that they would for LIBOR. Therefore, SOFR caps have traded at a premium to the LIBOR equivalent structures since banks must charge for the basis risk they face. We've included pricing comparing various structures below to help illustrate this.

Notional	\$25,000,000		
Index	1-month LIBOR		
Ratings	Freddie Mac		
Strike	3 Years	4 Years	5 Years
1.00%	\$ 36,000	\$ 84,000	\$ 175,000
1.50%	\$ 26,000	\$ 56,000	\$ 113,000
2.00%	\$ 24,000	\$ 40,000	\$ 86,000
2.50%	\$ 20,000	\$ 30,000	\$ 65,000

Notional	\$25,000,000		
Index	NY FED 30D SOFR		
Ratings	Freddie Mac		
Strike	3 Years	4 Years	5 Years
1.00%	\$ 54,000	\$ 110,000	\$ 210,000
1.50%	\$ 43,000	\$ 80,000	\$ 145,000
2.00%	\$ 39,000	\$ 64,000	\$ 115,000
2.50%	\$ 35,000	\$ 53,000	\$ 92,000

The cost difference between the two indices is subject to fluctuate as banks adjust their models, new developments are announced, and other banks enter the space. However, we're expecting this premium to subside over time as the market becomes more liquid.

In some cases, Freddie Mac is temporarily allowing the purchase of a LIBOR based hedge for SOFR loan products. That said, there are some additional requirements which the borrower must agree to in order to do so. Per the Freddie website, these include:

- Borrower will be required to make monthly replacement cap reserve deposits with the servicer sufficient to purchase a replacement SOFR-based, third-party cap within 12 months of the loan closing.
- Lender will have the right to apply amounts in the reserve toward the purchase of a replacement SOFR-based, third-party cap under certain circumstances.
- A guarantor will guarantee payment of the difference between the reserve amount and the cost of the replacement cap.
- Borrower and the cap provider will agree to use Freddie Mac's updated form LIBOR cap documentation, including provisions governing the transition to SOFR.

We've seen some clients choose to purchase the LIBOR cap and others elect to proceed with SOFR. As always, we're happy to show comparative pricing for both to help dial on the option which meets the lender's requirements and makes the most sense for you.

What to expect going forward

Cap executions that feel the same as they did based on LIBOR. There's no need to worry about the cap impacting your closing, the process hasn't changed and is as smooth as before.

Many banks are wrapping up document negotiations with Freddie and Fannie and are targeting late this year or early next year to be in a position to trade SOFR caps. We're optimistic that as more banks enter the space, and markets become more liquid, the premium for SOFR caps will ease.

Development of forward-looking term rates using some combination of SOFR futures and SOFR OIS transactions. The ARRC's [2020 Objectives](#) set the first half of 2021 as the goal for creating a term reference rate based on SOFR derivatives markets. More on this later.

Please don't hesitate to reach out should you have any questions or if we can do anything to help.

Resources

- <https://www.newyorkfed.org/arrc/sofr-transition>
- https://mf.freddiemac.com/news/2020/20200817_libor_transition_update.html
- https://multifamily.fanniemae.com/news-insights/multifamily-wire/new-arm-5-5-sofr-indexed-sarm-arm-7-6-and-hybrid-arm?_ga=2.153708728.1269969991.1603812566-1273951460.1603812566
- https://mf.freddiemac.com/news/2020/20200724_sofr_based_loan_rate_cap_announcement.html

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