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Outdated

Libor Transition: FFIEC Statement on Managing the Libor Transition and Guidance for Banks

To

Chief Executive Officers of All National Banks, Federal Savings Associations, and Federal Branches and Agencies; Department and Division Heads; All Examining Personnel; and Other Interested Parties

References to reputation risk have been removed from this bulletin as of March 2025. Removal of reputation risk references is identified by a strikethrough. Refer to OCC Bulletin 2025-4.

Summary

The member agencies of the Federal Financial Institution Examination Council (FFIEC) today issued a statement regarding the risks of expected cessation of the London Interbank Offered Rate (Libor) after the end of 2021. The

FFIEC statement encourages supervised institutions to prepare for this transition and address associated risks.

This OCC bulletin expands on the FFIEC statement and provides banks[1] with guidance for identifying applicable risks, planning, and successfully transitioning to replacement rates. The concepts in this OCC bulletin also generally apply to the cessation of other interbank offered rates, should such cessations occur.

Note for Community Banks

This OCC bulletin applies to community banks, but the applicability of some concepts depends on the nature and extent of the banks' Libor exposure.

Highlights

The FFIEC statement attached to this bulletin addresses

- risks to institutions.
- assessing Libor risk exposure.
- contract fallback language.
- consumer impact.
- third-party service provider considerations.
- supervisory activities.

In this bulletin, the OCC expands on the FFIEC statement by providing additional guidance and information about risk management.

Background

While reference rates have ceased reporting in the past, the prevalence of Libor throughout the financial system creates the need for banks to prepare to transition away from Libor and manage the associated risks. There is risk of market disruptions, litigation, and destabilized balance sheets if existing contracts cannot seamlessly transition to new rate(s) or if alternative replacement rate(s) do not attract sufficient market-wide acceptance. A bank's risk exposure from Libor's expected cessation depends on the bank's specific circumstances.

Libor exposure can exist both on and off the balance sheet, including in the following categories:

- Derivatives (e.g., interest rate swaps, forward rate agreements, and futures)
- Cash instruments
  - Commercial loans (e.g., syndicated or non-syndicated business loans and commercial real estate loans)
  - Retail loans (e.g., adjustable rate mortgages, home equity lines of credit, credit cards, private student loans, and reverse mortgages)
  - Securities (e.g., floating rate bonds, notes, securitizations, and preferred stock)
- Funding
  - Borrowings (e.g., term and overnight borrowings)
  - Deposits (e.g., non-maturity and time deposits)

Many existing contracts do not include sufficient provisions in the event that Libor becomes unavailable, known as fallback language. Fallback language is a contractual provision that dictates how the replacement of a ceased reference rate will be handled. Many existing contracts do not contain sufficiently robust fallback language because many contracts include language to provide for only a temporary cessation of Libor, rather than permanent cessation. As banks are forming strategies to mitigate the risks from Libor's expected cessation, robust fallback language with clear and executable terms could help mitigate risks. The assessment of existing contracts, including contracts serviced by third parties, could be a challenging exercise in banks with varying contract language, particularly banks with merger and acquisition history, and larger, more complex banks that have lines of business that operate with more autonomy.

The extent of a bank's plans to address risks from expected Libor cessation is expected to be tailored to the bank's specific risks. For example, the plan for a bank with limited Libor exposure only in its investment portfolio is typically much simpler than a plan for a bank that has a concentration in commercial loans priced using Libor. All banks should identify and quantify their Libor exposure.

The OCC does not endorse a specific Libor replacement rate.

Risk Management

Libor is referenced globally, and its cessation could affect banks of all sizes through direct or indirect exposure.[2] Expected Libor cessation poses risks beyond market risk, including operational, strategic, ~~reputation~~, and compliance. Strategic and operational risks can arise from the failure to plan for, and implement appropriate controls around, Libor transition activities. Another important operational risk management consideration is how Libor is used in pricing, financial models, and other parts of banks' infrastructure, such as banks' core processors. Banks face potential compliance ~~and reputation~~ risk from the potential for disputes around contractual language. For example, fallback language in existing contracts might be vague regarding a replacement rate and spread adjustment due to the temporary cessation perspective. This could trigger contractual disputes or litigation between the bank and its customers or counterparties when transitioning to replacement rates. Communication with counterparties and customers should include the choices and methodology for determining the replacement rate and spread adjustment.

Many of the principles in OCC Bulletin 2017-43, "New, Modified, or Expanded Bank Products and Services: Risk Management Principles," apply to actions that banks may take to address expected Libor cessation.

Generally, banks should develop and implement plans to identify and control risk related to expected Libor cessation, similar to the cessation of other indexes.

In planning for the reference rate transition, banks should

- identify and quantify Libor exposure in all product categories and lines of business.
- determine the impact and updates needed to bank policies, processes, personnel, and control systems.
- assign responsibility for oversight to a committee, team, or individual.
- determine the operational complexity of maintaining infrastructure (e.g., models and systems) to accommodate Libor and replacement rate(s) and whether bank systems are equipped to handle the transition.
- develop a transition plan with defined milestones and deliverables that includes, as applicable,
  - plans to perform an assessment of all applicable risks.
  - plans to assess the potential impact to the bank's customers.
  - strategies to inventory, analyze, and assess the risk of existing contracts.
  - strategies to identify replacement rates, modify spreads, and modify existing contracts, as necessary.

    - processes to determine the laws and regulations applicable to contract renegotiations.
    - strategies to address third-party risk management issues.
    - communication plans for engaging with affected customers.
    - plans to identify, monitor, and resolve system constraints.
    - plans to revise and test financial models, including valuation and pricing models.[3]
    - plans for communicating with third parties that provide modeling, valuation/pricing, document preparation, or accounting services to the bank, and confirming that the third parties are working toward appropriate solutions.
- develop reports for senior management and the board to monitor progress in implementing the transition plan, and periodically communicate the progress to the board regarding the Libor transition.

Fallback Language

Fallback language is a contractual provision that dictates how the replacement of a ceased reference rate will be handled. Existing contractual fallback language is an important factor in bank reviews. Banks should take actions to ensure the appropriateness of fallback language in both existing contracts and new contracts, including

- analyzing fallback language in existing contracts and assessing whether the fallback language has clear and executable terms.
- assessing the appropriateness of contract elements for existing and new contracts. Examples of contract elements include triggers, replacement rates, and adjusted spreads. For example, banks should assess whether

    - the fallback language has specific triggers to enact the replacement rate.
    - the contract is clear regarding the replacement rate and spread adjustments.
    - the fallback language is appropriate in terms of minimizing valuation changes.
- planning for and monitoring the implementation of
    - communications with relevant counterparties.
    - renegotiating existing contracts. Contract renegotiation plans should be aligned with the bank's exposure.
    - entering into new Libor contracts with clear and executable fallback language.
    - determining a solution for Libor exposure through FHLB borrowings or government-sponsored enterprise/FHLB securities. Banks might also take into consideration what potential benchmark rate FHLBs and government-sponsored enterprises may adopt for their fallback language and new floating rate products.
    - addressing Libor-based securities in asset management lines of business.
- assessing the impact of various options under fallback language. Assessments may include the potential for valuation changes, liquidity impact, hedging implications, system changes needed, and customer impact.
- developing reports that monitor progress and challenges in renegotiating existing contracts.

Choice of a Replacement Rate

Bank management will generally need to evaluate and identify appropriate replacement rates and adjustment methodologies, based on the assessment of the bank's Libor exposures and needs for replacement rates.

When selecting replacement rates and adjustment methodologies, bank management should

- research the availability of replacement rates.
- assess the appropriateness of potential replacement rates specific to the bank's products.
- assess bank system capabilities of using replacement rates and develop plans to address system limitations.
- develop strategies to control the risks associated with illiquid or unavailable alternative rates.
- assess customers' receptiveness to transition to replacement rates.
- develop and implement strategies to assist customers to make the transition with minimum disruption.

Assessing and Controlling Risk to Earnings Related to Libor Transition

Transitioning to replacement rates could have a value transfer cost depending on the selection of a new rate, spread adjustment, and other factors.

When assessing and controlling risk to earnings, bank management should

- develop objectives and strategies for managing financial impacts to the bank and customer portfolios.
- perform scenario analysis of potential earnings impact due to Libor replacement.
- perform scenario analysis of potential demand for additional collateral due to a valuation change resulting from Libor replacement.

- prepare to meet accounting rules and requirements, such as hedge accounting, with respect to the Libor transition.

Implications for Asset Liability Management or Hedged Products

Banks face the potential for financial losses if the replacement of Libor affects the funding side of the balance sheet differently from the asset side. For example, if a bank is using FHLB Libor advances to fund its Libor-based mortgage lending, basis risk could arise if different reference rates replace Libor in the two types of transactions.

When banks use derivatives to hedge cash products, value transfer caused by Libor transition can be minimized if banks can apply the same triggers, replacement rates, and spread adjustments in the fallback language to both the cash products and the derivatives. The International Swaps and Derivatives Association (ISDA) has published its consultations on benchmark fallbacks[4] and expects to implement a new fallback definition and protocol. ISDA may adopt a compounded in arrears rate approach[5] for the replacement rate and historical mean/median approach for spread adjustment. If ISDA adopts this approach, there are potential implications for cash products that are hedged with derivatives, and banks may have to choose similar approaches for cash products to minimize basis risk.

Bank management should

- develop strategies and implementation plans for hedged products and monitor the bank's progress and challenges in implementing the strategies.

- address the potential need to hedge basis risk arising from changes related to Libor in valuation, pricing, interest paid on collateral, and other areas.

Further Information

Please contact Ang Middleton, Risk Specialist, Treasury and Market Risk, Bank Supervision Policy, or Chris McBride, Director of Treasury and Market Risk, Bank Supervision Policy at (202) 649-6360.

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Related Link

- "Joint Statement on Managing the LIBOR Transition" (PDF)

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[1] "Banks" refers collectively to national banks, federal savings associations, and federal branches and agencies of foreign banking organizations.

[2] Many community banks may not offer products or services that use Libor. Community banks could, however, have Libor exposure in such positions as Federal Home Loan Banks (FHLB) borrowings, mortgage-backed securities, or bonds in the banks' investment portfolios.

[3] For more information, refer to OCC Bulletin 2011-12, "Sound Practices for Model Risk Management: Supervisory Guidance on Model Risk Management."

[4] Refer to ISDA press release, "ISDA Publishes Two Consultations on Benchmark Fallbacks" (May 16, 2019).

[5] Compounded in arrears means the fallback could be to the relevant risk-free rate observed over the relevant Libor tenor and compounded daily during that period.

Topic(s): ▪ CAPITAL MARKETS