Farm Credit Administration

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INFORMATIONAL MEMORANDUM

September 11, 2018

To: Chair, Board of Directors
Chief Executive Officer
Each Farm Credit System Institution[1]

From: Samuel R. Coleman, Director and Chief Examiner
Office of Examination

Subject: Planning for LIBOR Phase-Out

We, the Farm Credit Administration, are issuing this informational memorandum to provide guidance to Farm Credit System (System) institutions on planning and preparing for the expected phase-out of the London Interbank Offered Rate (LIBOR).

The United Kingdom's Financial Conduct Authority, which is the regulatory agency that supervises LIBOR, announced in July 2017 that it will phase out its support of LIBOR by the end of 2021, and it could not guarantee the stability of this benchmark rate beyond that date.[2]

Since that announcement, various industry workgroups have begun preparing for the phase-out, including publishing and promoting the Secured Overnight Financing Rate (SOFR) as a new alternative benchmark rate. The Federal Reserve Bank of New York began publishing SOFR in April 2018. SOFR is currently a measure of overnight secured borrowing, but the financial industry plans to create term reference rates based on a SOFR derivatives and futures market. If this market develops as planned, then SOFR (or a SOFR average) could become the predominant new reference rate used by U.S. financial institutions.

Industry workgroups have emphasized the potential adverse consequences if market participants do not effectively plan and prepare for the LIBOR phase-out. The System must prepare for the phase-out because it has significant exposures to loans, debts, investments, derivatives, and preferred stock with interest rates that are indexed to LIBOR. In addition, the large volume of financial instruments and processes that need adjustment may require

[1] Guidance to the Federal Agricultural Mortgage Corporation (Farmer Mac) will be provided separately by FCA's Office of Secondary Market Oversight.

[2] Although banks may continue to submit LIBOR quotes beyond 2021, the Financial Conduct Authority and the ICE Benchmark Administration could still terminate trading in LIBOR in their regulated markets if they determine that LIBOR has degraded and no longer provides a realistic measure. When LIBOR phases out, a global reference rate may no longer exist.

considerable work. Inadequate planning and preparation could expose institutions to substantial risks, including operational, legal, interest rate, liquidity, and reputational risks.

While the System has established a LIBOR workgroup to provide leadership in addressing the phase-out, each System institution must take responsibility for addressing the resulting risks and coordinating its actions with other System institutions — both in their own district and across the System.

Therefore, your institution should develop a multi-year LIBOR phase-out transition plan and incorporate it into your annual business plan, beginning with the 2019 business plan. The transition plan should define an orderly roadmap of actions that will reduce LIBOR exposures over time and prepare for the phase-out.

The plan should be specific to your institution and address the unique risk exposures resulting from your balance sheet and risk management practices. Also, your institution should periodically update the plan to reflect changing conditions, industry developments, and the results of your ongoing risk assessments and actions.

The following is a list of guidelines you should use when developing your institution's transition plan. They are consistent with recommendations in industry and trade publications discussing the phase-out.

- **Establish a governance structure to manage the transition.** This includes appointing a senior executive to be accountable for and to supervise the transition, providing regular updates to the board, and allocating budget and staffing.

- **Assess exposures to LIBOR.** This includes inventorying and quantifying financial instruments referenced to LIBOR, calculating exposures expected to roll off by year for the life of your institution's LIBOR exposures, and providing regular reports to the board to monitor changes in exposures during the transition period. This also includes evaluating the potential impact of the phase-out on interest rate risk (particularly basis risk), financial instrument valuations, and hedge accounting and effectiveness.

- **Assess fallback provisions in contracts and the impact of a LIBOR phase-out under those provisions.** This includes identifying legacy contracts where fallback provisions are inadequate, actions required to amend the contracts, and the stakeholder outreach that is necessary.[3] Be sure that any new contracts linked to LIBOR have robust fallback language that allows for a smooth transition.[4]

- **Establish strategies for reducing each type of LIBOR exposure.** Your institution should limit the continued build-up of LIBOR exposures to reduce the

[3] The fallback language in legacy contracts was generally intended to address a temporary unavailability of LIBOR — not its permanent discontinuation or degradation in quality. As a result, your institution may need to reach out to stakeholders to adjust these provisions.

[4] In July 2018, the Alternative Reference Rate Committee (ARRC) convened by the Federal Reserve Bank of New York published Guiding Principles for developing fallback language. The committee's working groups are developing specific contract language by product type for industry consideration. For updates on committee activities, go to the announcements page on the ARRC website.

conversion work required. When possible, strategies should allow existing LIBOR exposures to roll off to facilitate a quicker decline in legacy contracts.

- **Assess operational processes that need to be changed.** For example, to be able to handle new reference rates, your institution may need to adjust the following:
  - Loan accounting systems
  - Management information systems
  - Risk measurement and models
  - Funds transfer pricing and other pricing systems

  In addition, be sure that your operational processes can handle converting a potentially large volume of contracts to fallback provisions at the same time.

- **Define communication strategies with customers and other stakeholders.**

- **Establish a process to stay abreast of industry developments and best practices as soon as they become available, and modify the transition plan accordingly.**

- **Establish a process to stay abreast of actions taken at the System and district levels to ensure a coordinated approach as much as possible.** For example, some changes at associations may require support from System banks and service providers.

- **Include action steps and assign timeframes in your transition plan for completing each key objective, particularly for the following:**
  - Reducing LIBOR exposures
  - Revising fallback language in legacy contracts and new contracts
  - Revising operational processes
  - Communicating with stakeholders

While timeframes for implementing an alternative benchmark will depend on market and industry developments, you may begin taking some steps right away to prepare for the LIBOR phase-out. Be sure to modify your transition plan as market developments occur; your plan should become more defined as broader market milestones are achieved.[5]

Our examiners will begin reviewing LIBOR transition plans in February when we evaluate 2019 business plans. They will use the guidelines listed above when assessing your institution's transition plan.

If you have any questions, please contact your examiner-in-charge or FCA's LIBOR phase-out workgroup at LIBORphaseout@fca.gov.

[5] At its Oct. 31, 2017, meeting, ARRC adopted a broadly defined "paced transition plan" outlining the key stages for an orderly market transition away from LIBOR and toward the new SOFR reference rate. The paced transition plan was published as an attachment to the committee's meeting minutes.