Practical Implementation Checklist for SOFR Adoption

September 2019

INTRODUCTION:
The Alternative Reference Rates Committee (ARRC) [1] is a group of private-market participants that was convened by the Federal Reserve Board and Federal Reserve Bank of New York in cooperation with other U.S. agencies to promote successful transition from U.S. Dollar (USD) LIBOR. Time is of the essence for market participants to prepare given the likelihood that LIBOR will become unusable after 2021[2].

The ARRC recognizes the importance of providing market participants further clarity on the practical considerations for the transition from LIBOR, and that additional information may be useful to certain firms that have not yet fully commenced taking steps to transition. The ARRC's "Practical Implementation Checklist for SOFR Adoption" or "Checklist" was developed as an informational document for market participants. It contains a series of considerations across a set of categories of work. There is a one-page summary followed by details for 10 categories.

Statements made by regulators have clearly expressed that (i) the discontinuation of LIBOR is a certainty[3] and (ii) market participants should take appropriate action to transition from LIBOR to an alternative risk free rate.[4]

The Secured Overnight Financing Rate (SOFR) is the ARRC's recommended alternative to USD LIBOR, and the ARRC has published a Paced Transition Plan[5] with specific steps and timelines to encourage adoption of the rate. The ARRC continues to coordinate industry efforts, including by: encouraging an expanded membership and participation in its working groups; supporting the adoption of SOFR; developing robust fallback language; and creating educational materials for market participants. In addition, Federal Reserve Board staff holds weekly office hours to answer questions from market participants on the transition.

Important disclosures about the checklist:

- It is provided for informational purposes only.
- It does not constitute legal, accounting or financial advice and is not exhaustive.
- It does not define regulatory or supervisory expectations.
- It focuses on the needs of impacted firms with USD LIBOR exposures but does not address non-dollar exposures. All mentions of LIBOR in this checklist, should be considered as referring to USD LIBOR.
- While it might be helpful for other types of users, it is focused on banking institutions.

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[1] The ARRC is a group of private-market participants convened by the Federal Reserve Board and the New York Fed, comprised of a diverse set of private-sector entities that have an important presence in markets affected by USD LIBOR and a wide array of official-sector entities, including banking and financial sector regulators, as ex-officio members.
[2] Source: The FCA Statement on LIBOR Panels, November 2017, the Future of LIBOR July 2017
[3] Source: Opening Statement of Chairman J. Christopher Giancarlo before the Market Risk Advisory Committee Meeting, July 2018
[4] Source: LIBOR: Preparing for the End, July 2019
[5] Source: The ARRC's Paced Transition Plan, adopted in October 2017

Practical implementation checklist summary

The LIBOR transition is a significant event impacting a broad set of financial products and market segments. Given how deeply embedded LIBOR is in the financial ecosystem, it is important to properly plan, mobilize, and execute a program that encompasses all of a firm's businesses and functions. This checklist was developed to provide considerations for impacted firms.

<u>**Summary - Simplified practical implementation checklist for SOFR adoption**</u>

1. **Establish Program Governance:** Implement a robust governance framework with accountable senior executives to oversee the delivery and coordination of the firm's enterprise-wide LIBOR transition program.

2. **Develop Transition Management Program:** Establish an enterprise-wide program across functions and businesses to evaluate and mitigate the risks associated with transition with specific considerations for unique product and client exposures.

3. **Implement Communication Strategy:** Develop and implement an enterprise-wide strategy with clear objectives to proactively engage, consistently communicate, and increase levels of education with impacted internal and external stakeholders.

4. **Identify and Validate Exposure:** Quantify and develop a flexible approach to monitor LIBOR-linked exposures through the transition period. Obtain or develop capabilities to value SOFR-based products as part of transition to using those products.

5. **Develop Product Strategy:** Develop strategy for redesigning or transitioning the existing portfolio of LIBOR products, including creating or using new products based on SOFR.

6. **Risk Management:** Identify, measure, monitor and control financial and non-financial risks of transition, establishing processes and oversight routines for ongoing management.

7. **Assess Contractual Remediation Impact and Design Plan:** Understand the financial, customer, and legal impacts resulting from transitioning from LIBOR to SOFR via fallbacks, and plan mechanisms for implementing.

8. **Develop Operational and Technology Readiness Plan:** Develop a plan to address the large-scale operating model, data and technology implications required for LIBOR transition.

9. **Accounting and Reporting:** Determine accounting considerations along with related reporting considerations.

10. **Taxation and Regulation:** Determine the tax and regulatory reporting considerations.

Practical implementation checklist

Detailed practical implementation checklist for SOFR adoption

1. Program Governance

Goals: Implement a robust governance framework with accountable senior executives to oversee the delivery and coordination of the firm's enterprise-wide LIBOR transition program.

1.1. Appoint Executive Sponsor(s) and accountable Senior Executive(s) to coordinate and oversee multi-year LIBOR transition program activities across impacted business lines and functions.

1.2. Identify accountable business sponsors, project/workstream leads, and supporting project management staff to execute transition program activities.

1.3. Determine approach for rollout of program governance and management framework to all impacted business lines and enterprise functions.

1.4. Mobilize a Steering Committee chaired by the Executive Sponsor(s), with appropriate senior leadership representation across all business lines and enterprise functions.

1.5. Define cadence for periodic communications and reporting with senior management, Board of Directors, Executive Management Committee(s) and appropriate sub-committees.

1.6. Define and prioritize program objectives, success criteria and internal milestones in line with the ARRC's Paced Transition Plan (and other known industry milestones).

2. Transition program mobilization

Goals: Establish an enterprise-wide program across functions and businesses to evaluate and mitigate the risks associated with transition from LIBOR, with specific considerations to unique product and client exposures.

2.1. Conduct a comprehensive impact assessment across key focus areas including, but not limited to, financial products, contracts, business process (including systems and models).

2.2. Develop an implementation roadmap across a prioritized set of projects with specific considerations outlined for impacted businesses, products and enterprise functions.

2.3. Confirm resource and budget needs to deliver the activities in the implementation roadmap.

2.4. Establish a project management framework to monitor the progress of the implementation plan, identify and escalate risks.

2.5. Proactively monitor and adjust the implementation plan based on evolving and/or shifting external industry and/or regulatory developments.

3. Communication strategy

Goals: Develop and implement an enterprise-wide strategy with objectives to proactively engage, consistently communicate, and increase levels of education with impacted stakeholders including senior management or the Board if needed.

3.1. Define the key objectives and priorities of the external communication plan, align, and achieve consistency with internal communication efforts.
3.2. Confirm internal and external impacted groups (clients, regulators, trade associations, the ARRC and other working groups), prioritizing and segmenting as appropriate
3.3. Confirm communication channels/sources to be used.
3.4. Develop materials for internal and external stakeholders, as appropriate (e.g. formal training material and educational videos, newsletters, client disclosures).
3.5. Educate internal stakeholders (including business leadership) on LIBOR transition program objectives, industry developments and relevant business impacts.
3.6. Provide clear and consistent messaging on transition impacts to external stakeholders including clients and investors.
3.7. As needed, work to bolster external relationships to proactively manage legal, conduct, and reputational risks.

4. Exposure management and valuation

Goals: Quantify and develop a flexible approach to monitor LIBOR-linked product exposure through the transition period. Develop capabilities to value SOFR-based products.

4.1. Conduct a product exposure analysis to determine the LIBOR-linked exposures for each line of business (by asset class, tenor and maturity) including off-balance sheet exposures such as lines of credit.
4.2. Quantify exposures for LIBOR products maturing beyond year-end 2021.
4.3. If use / issuance of LIBOR is continuing, develop a repeatable process for evaluating and reporting what will be post-2021 exposures for trend analysis, sizing of effort, and management.
4.4. Construct / obtain access to a SOFR interest rate curve to be used for pricing SOFR-based products calculating interest on USD collateral and discounting USD-denominated derivatives.
4.5. Understand SOFR historical data needs for valuation, pricing system, and model updates.

5. Portfolio and product strategy

Goals: Develop strategy for redesigning (or transitioning) the existing portfolio of LIBOR products, including creating or using new products based on SOFR.

5.1. Define business strategy and timeline for reducing the reliance on LIBOR for new product issuance; define milestone for discontinuation of new LIBOR product issuance.
5.2. Define timelines for offering of new SOFR-linked products, considering alignment of hedged product timing.
5.3. Define risk and new product approval requirements for SOFR-linked product issuance. Look for economies across products.
5.4. Understand what others in the industry are doing for non-LIBOR products and begin process of building / obtaining new product capabilities.

6. Risk management

Goals: Identify, measure, monitor, and control financial and non-financial risks of the transition, and establish processes and oversight routines for ongoing management of the identified risks.

6.1. Define the key transition risks resulting from LIBOR discontinuation (including market readiness, business impacts, financial and legal risks) and assess across the firm's defined risk framework.

6.2. Establish processes to measure and monitor the identified material risks under baseline and alternative transition scenarios (e.g., market adoption, product and currency liquidity; current and stress market conditions). Assess the impact to interest income, funding, liquidity and capital levels.

6.3. Identify mitigating actions to address identified transition risks with focus on product, basis, operational and conduct risk.

6.4. Establish processes for updating business and enterprise-level risk management routines.

6.5. Periodically report the identified material risks to senior management.

6.6. Assess impact to risk models and develop processes for updating including guidelines for validation requirements.

6.7. Establish role of key control functions such as Internal Audit.

7. Contractual remediation

Goals: Understand the financial, customer, and legal impacts resulting from transitioning from LIBOR to SOFR for legacy contracts that may need to use their contractual fallback.

7.1. Review existing LIBOR-related contracts to determine the impact of fallbacks. This should include inventorying the triggers, changes to terms, financial impact, customer impact, and legal interpretations. The review should assemble relevant information into a vehicle for capturing contractual data.

7.2. Using this review, project the impact if the fallbacks have to be executed and use this to inform future steps and priorities. This is a combination of expected financial, legal, customer, and operational impact.

7.3. For new contracts that reference LIBOR, make every effort to incorporate recommended fallback language developed by ARRC, the International Swaps and Derivatives Association, and other industry working groups.

7.4. For existing contracts that reference LIBOR, define approach and prioritization strategy for renegotiating / repapering contracts so as to include enhanced fallbacks or other amendments simplifying transition. The approach should consider the work required to remediate in advance and how to realize economies of scale. As soon as possible, begin either (a) amending contracts to incorporate enhanced fallback language, or (b) determining if contracts can be renegotiated or closed out prior to end-2021.

7.5. Assuming a material number of contracts cannot be remediated, determine size and program needed to implement fallback language as written, and begin planning for implementation. Note this should include customer notification processes.

8. Operational and technology readiness:

Goals: Develop a plan to address the large-scale operating model, data, and technology implications to enable a successful transition.

8.1. Assess where LIBOR is used front-to-back across all affected business and operations. Different business lines will have different exposures and need different levels of prioritization.

8.2. For each business line, and for core functions such as Finance or Treasury, inventory technology, operations, and modeling tools to understand specifically where they are using LIBOR.

8.3. Develop a process to incorporate new market data sources and related new calculation methodologies into firm systems. As new products using new rates emerge it will be essential to be consistent with industry best practices.

8.4. Define requirements and implement capabilities to build SOFR/other new rate financial products that will be the replacements for LIBOR products.

8.5. Support the technology needs of fallback processing (item 7).

8.6. Build testing plan(s) for new product capabilities, models / model validation and the operationalization of fallback processing. Ensure the readiness plan will encompass oversight of the readiness state of material operational and technology vendors.

8.7. Begin to plan for internal testing, third party validation / readiness for transition, and potentially for industry-wide testing.

9. Accounting and Reporting

Goals: Determine the technical accounting considerations along with related reporting considerations

9.1. Identify and understand impacts to hedge accounting standards and processes based on current guidance[6] (e.g., hedge de-designation, ineffectiveness).

9.2. Identify and understand impacts to accounting standards and processes for cash products, tracking accounting developments as finalized.

9.3. Identify impact on fair value accounting and impairment to P&L, credit allowances, and changes to the fair value hierarchy.

9.4. Identify impact on current state finance systems, operations, reporting and assess control environment for impacted processes.

9.5. Determine transfer pricing implications of a multi-rate environment on intercompany funding arrangements and derivatives.

9.6. Update financial disclosures accordingly.

10. Taxation and Regulation

Goals: Determine the tax and regulatory considerations along with related reporting considerations.

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[6] The ARRC is seeking regulatory relief from U.S. prudential and other market regulators as well as the Financial Accounting Standards Board to facilitate the transition from LIBOR to SOFR. For example see the April 2019 Tax Issues Letter from the ARRC.

10.1. Identify and understand tax impact of hedge accounting based on current guidance. Tax documentation may need to be updated to ensure hedging continues to be effective.

10.2. Determine tax accounting and compliance implications including, but not limited to, implications of taxable gain / loss to debt holders and swap counterparties.

10.3. Determine impact of tax on regulatory capital. Forecast potential impact of deferred tax assets on Common Equity Tier 1 and Risk Weighted Assets.

10.4. Determine tax reporting requirements.

10.5. Identify if regulations such as those covering public companies or other types or regulated entities would require disclosure of the impact of the issue in public filings or in other disclosures—and if so, begin process of making such disclosures.

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