STATEMENT OF
KEVIN P. WALSH
DEPUTY COMPTROLLER FOR MARKET RISK POLICY
OFFICE OF THE COMPTROLLER OF THE CURRENCY

before the
SUBCOMMITTEE ON INVESTOR PROTECTION,
ENTREPRENEURSHIP AND CAPITAL MARKETS
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES
April 15, 2021

Statement Required by 12 U.S.C. § 250:
The views expressed herein are those of the Office of the Comptroller of the Currency and
do not necessarily represent the views of the President.
Chairman Sherman, Ranking Member Huizenga, and members of the Subcommittee, thank you for the opportunity to appear today to discuss the upcoming cessation of the London Interbank Offered Rates (LIBOR), the Office of the Comptroller of the Currency’s (OCC) efforts to ensure the institutions we supervise prepare for this transition, and legislation to provide certainty for the contracts held or serviced by national banks and federal savings associations (banks) that reference LIBOR.

I serve as the OCC’s Deputy Comptroller for Market Risk Policy and I am responsible for directing market risk activities, including policy formulation and risk monitoring for trading activities, derivatives, structured products, liquidity, interest rate risk, asset management and asset servicing. I serve as the agency’s ex-officio member of the Alternative Reference Rate Committee (ARRC), which is composed of private sector entities and other ex-officio members to address issues surrounding LIBOR cessation and replacement. I also oversee the agency’s representation on other domestic and international committees associated with LIBOR’s cessation.

The transition from LIBOR to other benchmarks is ongoing and will become more urgent at the end of 2021 when certain U.S. dollar LIBOR tenors will be discontinued. In 2018, to prepare for the transition, the OCC began working with regulated institutions to promote their safe and sound transition away from LIBOR by encouraging them to develop transition plans, remain abreast of ongoing developments, and analyze the impact of this transition on their operations. The Secured Overnight Financing Rate (SOFR), developed by the ARRC and the Federal Reserve Bank of New York is one of several alternative reference rates that can replace LIBOR for contracts held or serviced by OCC-regulated large, midsize, and community banks.
In my testimony today, I will describe our supervisory approach to the LIBOR transition, including the regulatory guidance we have provided to the entities we supervise to support the transition, the preparedness of the industry, and our views on the draft “Adjustable Interest Rate (LIBOR) Act of 2021.”

**Background**

The OCC charters, supervises, and regulates nearly 1,200 national banks, federal savings associations, and federal branches of foreign banks (collectively, banks), that cover a broad spectrum of asset sizes and banking business models. Our supervised banks range in size from very small community banks to the largest, most globally active U.S. banks operating in the United States. The vast majority have less than $1 billion in assets, while more than 60 have greater than $10 billion in assets. Together, they hold $14.5 trillion in assets—almost 70 percent of all the assets of commercial U.S. banks.

LIBOR is a key interest rate benchmark used since the 1970’s and referenced in $223 trillion\(^1\) worth of U.S. dollar contracts across global markets. In 2012, it became clear that some international bank employees manipulated LIBOR for profit, and this revealed shortcomings in the benchmark rate and the need for significant reforms. Today’s LIBOR alternatives are supported by quantitative data rather than the qualitative support used for LIBOR.

**OCC’s Supervisory Approach to the LIBOR Transition**

OCC-regulated institutions use or are exposed to LIBOR in many different ways. The smallest community banks we supervise are exposed through third-party activities tied to LIBOR, while the largest banks we supervise rely heavily on LIBOR in their lending, derivatives

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\(^1\) Federal Reserve staff calculations as of 4Q, 2020.
activities, and market-making capacities. Therefore, the OCC, both individually and collectively with the other federal banking agencies, has been proactive to ensure that community, midsize and large banks are prepared for LIBOR’s cessation.

The OCC has consistently advocated for thoughtful and timely preparedness on the part of the banks we supervise when considering the cessation of LIBOR. The OCC does not endorse any specific replacement rate for LIBOR, and the industry’s efforts to develop replacement benchmarks continue. Nevertheless, there is much that banks can and have done to prepare, and the OCC has been working closely with the industry to this effect.

The OCC developed a phased approach to govern our expectations for banks while they prepare for the transition. We focused our efforts in 2019 on making banks aware of the transition and encouraging them to carefully inventory their exposures and become familiar with our supervisory expectations. In 2020, the OCC emphasized bank preparedness, and in 2021, we are turning our attention to banks that may need additional support or assistance for a smooth transition.

The OCC expects each bank to develop a comprehensive plan to address the potential effects of LIBOR cessation that is tailored to the bank’s particular exposure to LIBOR under its current business model, risk profile, and strategic plan. As each bank evaluates its exposures to LIBOR, it should determine the scope of work necessary to manage the risks associated with those exposures, and to develop a concrete plan to perform that work. To date, more than 95 percent of the institutions we supervise have gone through the process to quantify their exposure.

The OCC has been actively engaged through banker outreach and supervision activities to convey this message and to assess banks’ progress for the past several years. Starting in 2018,
OCC hosted meetings and outreach sessions with bank Chief Executive Officers, Chief Financial Officers, Chief Risk Managers and Bank Directors to ensure their awareness of LIBOR’s cessation, and to encourage them to consider their exposures, risk tolerances and future plans. We also first mentioned the need for LIBOR transition plans in our Semiannual Risk Perspective in 2018 and have continued to publish guidance documents to set forth our expectations of bank transition activities.

In 2019, the OCC developed an internal supervisory guidance document to assist our examiners in conducting discussions and assessing bank planning and preparation toward LIBOR cessation. As part of the Federal Financial Institutions Examination Council (FFIEC)’s LIBOR Coordination Group, the OCC also supported joint interagency guidance in July 2020\(^2\) to highlight the importance of bank preparedness and the potential risks to banks if they do not prepare appropriately. The OCC expanded on the FFIEC’s statement with OCC Bulletin 2020-68 which provided additional guidance and information to the industry about our risk management expectations.

In November 2020, the OCC published a joint letter\(^3\) with the Federal Reserve Board (FRB) and the Federal Deposit Insurance Corporation (FDIC) to provide additional guidance on reference rate transition, particularly related to loans. This statement reiterated that the agencies were not endorsing a specific replacement rate for LIBOR for loans, but that a bank may use any reference rate for its loans that it determines to be appropriate for its funding model and customer needs. However, the statement noted that the bank should include fallback language in its

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lending contracts that provides for use of a robust fallback rate if the initial reference rate is discontinued. That same month, the OCC, FRB and FDIC issued a joint statement\(^4\) that encouraged banks to cease entering new contracts that use LIBOR as a reference rate as soon as practicable, but no later than December 31, 2021. We reiterated that we expect banks to stop creating new LIBOR exposures as of the end of this year with only a few exceptions to support functioning markets. Internally, the OCC also developed a work program to assist examiners in assessing the appropriateness of banks’ LIBOR transition planning, execution and related oversight, and reporting. This work program was made available to examiners last November. In February 2021, we issued a bulletin entitled “Libor Transition: Self-Assessment Tool for Banks”\(^5\) which provided a resource for a bank to assess and evaluate the appropriateness of its LIBOR transition plan, bank management’s execution of the bank’s transition plan, and related oversight and reporting. The self-assessment tool included a series of questions related to bank exposure assessment and planning, consideration of replacement rates and spread adjustment methodologies, an analysis of fallback language, a view of bank progress, and oversight of LIBOR cessation preparedness. The tool is intended to help bank management evaluate, identify and mitigate the bank’s transition risks.

OCC examiners have advised the banks we supervise to look outside their lending activities to determine whether they have LIBOR exposures in other contexts. For example, a bank may own a LIBOR-based loan participation interest, or may hold an instrument for the bank’s investment or liquidity portfolio that pays LIBOR-based income or otherwise reflects LIBOR exposures. If the bank is using a third-party vendor to provide financial valuation.

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updates, or to provide cash flow analysis of borrower collateral or bank assets, the vendor may be employing discounting methods using LIBOR-based rates. Even if none of these considerations currently present issues for the bank, we believe management should be screening new investments and activities for embedded LIBOR exposures that may lead to future risks.

For those OCC-supervised banks that engage in LIBOR-based lending on a limited basis, such as commercial or residential real estate lending or small business loans, OCC examiners have consistently advised the banks of the limited amount of time the bank can continue to operate with the assurance that LIBOR rates will be available. These banks should be prepared to identify suitable replacement rates, to transition their future lending to those rates, to identify whether existing loans have terms extending beyond the LIBOR cessation, and to determine what transition and risk-management steps need to be taken. This process may present operational challenges that the banks will need to address depending on the bank’s available resources, the scope of the exposure, and the relative financial sophistication of the bank’s borrowers.

The OCC also supervises several globally-active banks with significantly larger balance sheets that have extensive LIBOR-based exposures. Most of these banks hold derivatives tied to LIBOR and a few of these banks are derivatives dealers that hold some of the largest blocks of LIBOR-sensitive asset and liability exposures in the marketplace. Because of the scope and size of their LIBOR exposures, the OCC’s large bank examiners are actively engaged in monitoring the adequacy of their planning and the effectiveness of their implementation. That effort has been aided by two recent development that are expected to ease the transition from LIBOR: the
new International Swap and Derivatives Association Protocols (ISDA)\(^6\) and a recently enacted New York state law. The ISDA protocols have provided market participants with a mechanism to add standardized fallback provisions into derivatives contracts. The New York state law makes SOFR the default benchmark replacement rate for many derivatives contracts that do not include fallback provisions, while still allowing for the adoption of alternative replacement rates. Taken together the ISDA Protocols and the New York statute have significantly reduced the risk of market disruption in the derivatives market from LIBOR’s cessation.

Unlike derivatives, loan and securities portfolios will be more complex given the nature of the instruments. Loans are typically negotiated between the parties and the applicability of a variety of state laws can make negotiations more complicated. Securities, notably securitized exposures, are complicated by the diverse investor bases that need to provide agreement to make changes to the rates. Banks continue to work on preparing these portfolios for the transition, but more work remains to be done.

Consumer products will also be affected by LIBOR cessation. Among the $223 trillion of U.S. dollar LIBOR contracts, about $1.4 trillion\(^7\) are in retail mortgages and other consumer loans. For example, many adjustable rate mortgages are indexed to LIBOR. In addition, many home equity lines of credit, auto loans, student loans and credit cards may be tied to LIBOR. When LIBOR is retired, these loans will have to be reset to any fallback benchmark clearly stated in the loan document.

Transitioning these legacy contracts will impact consumers directly. First, the Truth in Lending Act, Regulation Z, could be implicated when changing the index in a contract. The

\(^6\) ISDA protocols became effective January 25, 2021.
\(^7\) Federal Reserve staff calculations as of 4Q, 2020.
Consumer Financial Protection Bureau (CFPB) has proposed a rule to amend Regulation Z to address some of these issues. While the rule has not yet been finalized, it is important to note that the proposed rule provides a way under Regulation Z for a bank to transition from LIBOR without waiting for LIBOR to become unavailable as required under the current regulation. The proposed rule also requires that change-in-terms notices be sent for any home equity line of credit (HELOC) or credit card agreements when the LIBOR index is replaced, even if the margin is reduced. The CFPB has also provided guidance on LIBOR transition matters that do not require amendments to Regulation Z, such as how the LIBOR transition will affect adjustable rate mortgage (ARM) origination disclosures or ARM interest rate adjustment notices.

Because the OCC does not endorse any specific benchmark as a potential replacement for LIBOR, we anticipate banks may use more than one replacement as may be appropriate for different purposes. In every case, the OCC expects that each bank will make an informed analysis of which reference rates it should use to replace LIBOR. Those banks that have LIBOR exposures are in the process of determining the logistics of transitioning away from it and implementing necessary actions as appropriate including new data systems related to the replacement rates or re-hedging their books to reduce earnings impact from the end of LIBOR. During the supervisory process, the OCC will expect each bank to demonstrate that its selections are appropriate for the bank’s particular products, funding needs, and operational capacities.

**Fallback Clauses**

One key aspect of the LIBOR transition guidance relates to fallback clauses. Fallback clauses are provisions in a contract’s documentation that specify what will happen if the interest rate in the contract becomes unavailable prior to maturity. Banks that continue entering into new LIBOR-based contracts with maturities beyond December 2021 to support market conditions can
significantly reduce their risks during the transition by ensuring they use well-developed fallback clauses. Ideally, these clauses would include a description of the conditions triggering the change to a replacement benchmark, a clear designation of the replacement benchmark, and a clear and swift process for determining any changes to any spread over the reference rate. In setting these terms, each bank should, where possible, seek to minimize any valuation changes that will be triggered by the switch to the fallback rate. The bank should also understand how the change will be implemented as an operational matter, and how to mitigate any associated impacts on the bank’s liquidity risk and interest rate risk programs. For many types of contracts, banks may wish to consult model fallback language that has been developed and published by the ARRC and by relevant trade associations for different classes of credit products. For derivatives, banks will need to assess the extent to which the new ISDA protocols will cover all counterparties, or whether there are other documentation formats that need to be separately addressed.

Each bank will also need to assess the extent to which its agreements on existing LIBOR-based assets or liabilities contain fallback clauses. In many cases, legacy fallback clauses will not comprehensively resolve the bank’s risk exposures if LIBOR were to permanently cease to be available. Most are designed primarily to address a temporary interruption of LIBOR because of natural disasters or other unexpected events.

Ineffective fallback clauses expose a bank to reputation, credit, and litigation risk if the bank and the other party to the credit agreement cannot reach mutually-acceptable terms for addressing the cessation of the LIBOR benchmark. The OCC expects banks to assess their litigation risk on an informed basis by thoroughly reviewing their contracts for contractual limitations. But, more broadly, banks will need to assess ineffective fallback clauses under a framework that takes into account the differing nature of customers and counterparties for
different products. Communication and outreach to these customers may, in many cases, necessarily include an education component as the first step. Regardless of counterparty, the communication process and benchmark rate selections for all contracts must conform to all applicable regulatory requirements and standards.

Adjustable Interest Rate (LIBOR) Act of 2021

The OCC has reviewed the Adjustable Interest Rate (LIBOR) Act of 2021 and appreciates Congress’ efforts to provide clarity to contracts that do not have a fallback provision or a new rate designated. The draft legislation will be helpful in addressing systemic risks associated with the LIBOR cessation by permitting financial counterparties to agree to an appropriate reference rate or otherwise designate SOFR as the replacement rate. Further, the draft legislation would provide a safe harbor to help mitigate the potential for litigation which would be disruptive to the financial system, and clarity for individual banks, businesses and consumers who may be impacted by the transition. The OCC looks forward to working with the Subcommittee to perfect the language of the legislation to reduce ambiguity and provide a constructive roadmap for LIBOR participants.

Conclusion

The OCC has been actively working with our supervised institutions since 2018 to promote their preparation for the cessation of LIBOR. To avoid the risk of potential market disruptions, prolonged litigation, and financial impacts at the banks we supervise, the OCC has stressed the importance of making adequate transition plans—and successfully executing them—before LIBOR ceases to be reported. While the OCC does not endorse any specific replacement rate or rates that an individual bank determines are appropriate for continued operation of their
business model in a safe and sound manner, we are actively working with the banks we supervise to ensure their full preparedness. We are optimistic that banks have been planning appropriately for the transition and look forward to working with the Subcommittee to perfect legislation to help minimize any potential disruption that the transition may cause for banks and customers that have contracts without fallback provisions.