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ALERT MEMORANDUM

LIBOR Transition: Focus on Conduct Risk

10 December 2019

On 19 November 2019, the UK Financial Conduct Authority (the "FCA") published "Questions and answers for firms about conduct risk during LIBOR transition" (the "Q&As") to remind firms of the conduct risks associated with entering into LIBOR-referencing transactions that endure beyond end-2021.[1]

It is now well-known that LIBOR is expected to cease after end-2021, when the voluntary agreement of panel banks to continue to submit to LIBOR ends. Firms and other market participants need to have removed dependencies on LIBOR by this date to avoid disruption when publication of LIBOR ceases. In anticipation of firms increasing their efforts to transition away from the use of LIBOR, the FCA has published the Q&As to identify potential conduct issues arising from this transition under the following key themes: (1) governance and accountability; (2) replacing LIBOR with alternative rates in existing agreements and offering new products based on risk free rates; (3) communicating with customers; and (4) investing on customers' behalf. In this alert memorandum, we set out the key points from the Q&As including a checklist for conduct risk management, and an update on the LIBOR transition process.

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Key Points from the Q&As

— Buy-side as well as sell-side firms should be preparing for LIBOR transition.

— LIBOR transition should not be viewed as a narrow legal and compliance task.

— The FCA does not take a position on whether to replace LIBOR in legacy contracts by inserting "robust fall-back provisions" or by converting to alternative rates. However, the transition should not be used to move clients to rates that are "expected to be higher than what LIBOR would have been". We do not think the FCA requires firms to accurately predict whether a rate will be higher than LIBOR. The point is to be fair, clear and not misleading to customers.

— The Q&As offer a simple method of demonstrating that customers have been treated fairly: adopting a replacement rate that aligns with the established market consensus, and is recognised by relevant national working groups.

— Firms are not expected to give up the difference between LIBOR and SONIA resulting from the term credit risk premium built into LIBOR.

— The FCA will monitor firms' progress on ceasing new LIBOR cash contracts that mature beyond 2021 against the target date of end-third quarter 2020 set by the market-led Risk Free Rate ("RFR") Working Group.

— Firms can provide an objective overview of the benefits, costs and risks of a range of alternatives to a client's existing LIBOR-linked exposure, without inferring investment advice.

[1] https://www.fca.org.uk/markets/libor/conduct-risk-during-libor-transition.

Conduct Risk Management Checklist

Governance and Accountability

- ☐ Consider and address the potential impact and risk of LIBOR transition in an appropriately coordinated way across the firm. Develop a project plan including key milestones and deadlines.
- ☐ Ensure senior managers and boards are aware of the risks associated with LIBOR transition and take appropriate action.
- ☐ Recognise that LIBOR transition is likely to impact multiple business lines, operational areas, and geographical regions (for firms with international business) and involve a sufficiently diverse range of stakeholders.
- ☐ If your firm is within the Senior Managers and Certification Regime, identify a senior manager responsible for overseeing the transition away from LIBOR and detail the relevant responsibilities in the senior manager's statement of responsibilities, as well as relevant reporting lines and management information needs.
- ☐ Consider whether LIBOR-related risks are best addressed within existing conduct risk frameworks or whether a separate, dedicated programme is needed.
- ☐ Maintain effective processes and controls to identify, manage, monitor and report risks to your business, including risks associated with critical outsourced functions.
- ☐ Identify and prevent or manage conflicts of interest.
- ☐ Keep appropriate records of management meetings and committees to demonstrate that you have acted with due skill, care and diligence in your overall approach to LIBOR transition and when making decisions impacting customers.

Replacing LIBOR with Alternative Rates in Existing Agreements and Offering New Products Based on Risk Free Rates

- ☐ Treat customers fairly.
- ☐ Do not use LIBOR discontinuation to move customers with continuing contracts to replacement rates that are expected to be higher than what LIBOR would have been, or otherwise introduce inferior terms.
- ☐ Effectively communicate how new provisions are expected to operate (e.g., whether fall-back clauses operate at or before cessation, and on what basis).
- ☐ Consider the fairness of contractual terms under the Consumer Rights Act 2015 in respect of consumer contracts. Unilateral variation clauses are a key risk.

- ☐ Design new products based on alternative rates that meet customers' needs and perform as they are led to expect.
- ☐ Understand the inherent weaknesses in LIBOR. The transition should not be attributed solely to historic compliance issues.

Communicating with Customers

- ☐ Engage with customers early to raise awareness and educate them on the general implications and timing of LIBOR transition for both existing and new contracts.
- ☐ Take care in describing to the customers the risks associated with LIBOR ending and how it will affect them.
- ☐ Be mindful of, and manage, information asymmetries.
- ☐ Be aware that some customers may not fully understand the implications.
- ☐ Plan for and roll out increased engagement and client-specific conversations in the run up to end-2021.
- ☐ Ensure all client communications linked to LIBOR transition are clear, fair and not misleading. For example, where alternative options are presented for new products or to change existing LIBOR-referencing contracts, the range of options should be reasonable and fairly presented, including the benefits, costs and risks.
- ☐ Ensure relevant client-facing staff have adequate knowledge and competence to understand the implications of LIBOR ending and can respond to client queries appropriately, which may require additional training.
- ☐ Identify, across the firm any product-specific obligations which may require action in the context of LIBOR transition.

Investing on Customers' Behalf

- ☐ Manage any impact on contract continuity, expected interest payments and risks of declining liquidity in LIBOR-referencing products.
- ☐ Engage with issuers of LIBOR-referencing securities, derivatives and loans counterparties to convert these instruments and products to alternative reference rates.
- ☐ Create a plan for investment strategy and best execution that considers the costs and implications of LIBOR transition to deliver in the best interests of customers.

LIBOR Transition: State of Play

Bonds

— The Sterling Overnight Index Average ("SONIA") is the recommended RFR for sterling LIBOR. SONIA is now the norm in new issuances of floating rate sterling bonds and securitisations.

— The sterling RFR Working Group is working to publish lessons learned from conversions of legacy LIBOR instruments to SONIA.

— The US Alternative Reference Rates Committee ("ARRC") has released robust fall-back language to be included in new issuances of floating rate notes that reference USD LIBOR. These fall-back provisions set forth trigger events for the replacement of LIBOR, as well as the methodology for creating a term rate using the Secured Overnight Financing Rate ("SOFR") which is the recommended replacement RFR for USD LIBOR.

Loans

— LIBOR continues to be common in corporate lending, including in syndicated loans. The sterling RFR Working Group has set a target of Q3 2020 to stop new lending using LIBOR.

— The Loan Market Association ("LMA") has released, for comment on by market participants, exposure drafts of their recommended form of loan agreement referencing compounded SONIA and SOFR.

— The sterling RFR Working Group is supporting work to develop a forward-looking term SONIA rate. However, the development of such a rate relies on there being a robust and liquid derivatives market referencing SONIA, which is currently not the case. Firms should not delay the transition of agreements from LIBOR until forward-looking SONIA rates are developed.

— The LMA has also released, for comment by market participants, an exposure draft of a reference rate selection agreement to aid in the transitioning of English law loan agreements from LIBOR to alternative reference rates. The reference rate selection agreement is a form of agreement that can be used to amend each individual loan agreement.

Derivatives

— The uptake of alternative RFR-referenced derivatives transactions is steadily growing, but remains a small percentage of total amounts traded. The number of swap transactions referencing SOFR has reached 1,000 but SOFR swaps are still a small part of the US dollar swaps market.

— The International Swaps and Derivatives Association ("ISDA") has been engaging in consultations with market participants as to the form IBOR fall-back language should take in its IBOR fall-backs protocol, due to be released in January 2020. The results of these consultations indicate the methodologies for the adjustments that will be made to the derivatives fall-backs, as well as whether or not to include certain pre-cessation triggers for benchmark fall-backs, in the event that the regulators make a statement that a certain referenced IBOR is no longer representative of the underlying market.

— The European Supervisory Authorities have published a public statement to the effect that amendments made to legacy contracts for the sole purpose of introducing benchmark fall-backs should not create EMIR margin or clearing obligations on these legacy contracts.