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FCA Warns Firms of Conduct Risk During LIBOR Transition

The FCA has set out guidance for firms on how to manage conduct risk arising from the transition away from LIBOR to alternative benchmarks.

Key Points:

- The FCA has set out its expectations for firms, from a conduct risk perspective, as they plan and manage their transition away from LIBOR.
- The guidance is relevant to all firms with exposure to LIBOR, and covers key areas, including governance and customer communications.
- Firms should identify the Senior Manager responsible for overseeing LIBOR transition, and reflect this in the individual's Statement of Responsibilities.
- If firms have not done so already, they must implement plans for LIBOR transition.
- The FCA has also given a further speech on LIBOR, emphasising the work still to be done before the end of 2021.

At the end of 2021, the FCA will stop compelling panel banks to contribute data to LIBOR. There is a general expectation that, after this date, some, if not all, panel banks will cease their contributions — which could lead to the demise of LIBOR. On 19 November 2019, the FCA published a new webpage with guidance for firms concerning conduct risk during the transition away from LIBOR.

The FCA explains that firms have been keen to understand the regulator's core expectations during the transition, and so it has set out a series of questions and answers on conduct risk arising from the transition.

The FCA's June 2019 feedback statement on its Dear CEO letter on LIBOR transition highlighted this conduct risk. The Dear CEO letter was sent to major banks and insurers in the UK, asking for details of the preparations and actions firms were taking to manage the transition from LIBOR to alternative interest rate benchmarks. In its feedback, the FCA found that, as well as thinking about financial and operational risk, firms could be doing more to manage conduct risk arising out of the transition.

The FCA explains that its primary expectations of firms are that they:

- Have a strategy in place and take necessary action during LIBOR transition

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- Treat customers fairly by following FCA rules and guidance

The guidance itself addresses a number of different topics, which are summarised below. The questions and answers are relevant to all firms that currently rely on LIBOR. Although the FCA has used some sector-specific examples, it emphasises that the guidance is relevant to firms across various sectors.

Governance and accountability

The FCA's core expectation is that firms' senior managers and boards understand the risks associated with LIBOR transition and take appropriate action to move to alternative rates ahead of end-2021. Firms should identify the Senior Manager responsible for overseeing LIBOR transition, and reflect this in the individual's Statement of Responsibilities.

The FCA suggests that firms consider whether any LIBOR-related risks are best addressed within existing conduct risk frameworks or whether they need a separate, dedicated programme.

The FCA emphasises that, for many firms, LIBOR transition will affect their overall business strategy, and must not be viewed as a narrow legal and compliance risk. Firms will need to think about keeping appropriate records of management meetings or committees that demonstrate they have acted with due skill, care, and diligence in their overall approach to LIBOR transition and when making decisions impacting customers. This seems to be a hint that the FCA may review such records if it finds that firms have not managed LIBOR transition appropriately.

Replacing LIBOR in existing contracts and products

The FCA's core expectation is that firms take reasonable steps to treat customers fairly. The FCA notes that firms are more likely to be able to demonstrate they have fulfilled their duty to treat customers fairly if they adopt a replacement rate that aligns with established market consensus, reached through appropriate consultation, and that is recognised as an appropriate solution by relevant national working groups. However, the FCA acknowledges that industry initiatives are ongoing and market consensus is still developing, meaning that firms may ultimately have to exercise their own judgement.

Firms should also be aware of their obligations as supervised users of benchmarks under the EU Benchmarks Regulation. In particular, the obligation to produce and maintain robust written plans setting out the actions they would take in the event that a benchmark materially changes or ceases to be provided, to nominate alternative benchmarks when feasible and appropriate, and to reflect these plans in contractual relationships with clients. The EU Benchmarks Regulation provides that national competent authorities can request these plans from supervised users of benchmarks, and it would not be surprising if the FCA were to start requesting the plans from firms in the context of LIBOR transition.

In summary, users of LIBOR should:

- For legacy agreements
  - Identify all legacy agreements that reference LIBOR
  - Consider whether amendments to legacy agreements are required to reflect appropriate fallback and transition language, and whether amendments can in fact be made (*e.g.*, LIBOR users should evaluate amendment provisions, consent and notice requirements, voting rights, and "sacred rights" provisions that require 100% or other investor consents)

- Analyse economic consequences and challenges, such as basis risk and margin adjustment
- Identify liability issues relating to rate changes and/or inability to determine or change rate basis
- Survey tax considerations

- For new agreements
  - Identify a LIBOR alternative for agreements that will extend beyond 2021 (*e.g.*, SONIA and SOFR)
  - Ensure that appropriate fallback provisions, risk factors, and amendment provisions are included if LIBOR is to be used beyond 2021

The FCA advises that firms should consider the following factors when choosing replacement rates:

- LIBOR transition should not be used as an excuse to move customers to rates that are expected to be higher than LIBOR, or to otherwise introduce inferior terms
- Firms receiving LIBOR-linked interest are not expected to give up the difference between LIBOR and SONIA, which results from the term credit risk premium that is built into the LIBOR rate, but is not built into SONIA
- Firms using fallback provisions must communicate clearly how these provisions are expected to operate and when they would take effect
- Firms will need to consider whether any unilateral variation terms (and other contractual terms being introduced to address the transition away from LIBOR) are fair for the purposes of the Consumer Rights Act 2015

Offering new products that reference alternative rates

The FCA's core expectation is that firms should be offering new products that reference risk-free and other alternative rates, rather than LIBOR-linked products. The FCA emphasises that the best way to avoid the complications of calculating and explaining fallback provisions is to avoid new LIBOR contracts that mature after end-2021.

To the extent that firms continue to offer LIBOR-linked products that mature after end-2021, firms need to consider whether these products can meet the needs of customers, and continue to perform as customers are led to expect, both leading up to and following the discontinuation of LIBOR.

Communicating with customers about LIBOR transition

The FCA's core expectation is that firms must communicate information to customers in a way that is clear, fair, and not misleading. The FCA does not offer any specific guidance on the timing of communications, but states that information should be presented in good time to allow customers to make informed decisions about relevant products and the risks to which the customer may be exposed. The FCA also highlights that it may challenge firms if their communications with customers affected by LIBOR are delayed to the point that the client is left with insufficient time to understand their options and make informed decisions.

The FCA expects firms that continue to offer LIBOR-linked products that mature after end-2021 to explain fully to customers what will happen in the event of LIBOR ending, and its effect on the customer. As there remains a risk that customers do not fully understand how the end of LIBOR will affect them, the FCA states that firms should consider offering alternative products.

The FCA also emphasises that firms should not be overly concerned about providing regulated advice, as they 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 providing a personal recommendation. Therefore, firms should not use this concern as a reason to avoid engaging with customers.

Specifically, the FCA expects that firms:

- Engage with customers early to raise awareness, followed by increased engagement and client-specific conversations as the end of 2021 draws nearer
- Ensure that communications are clear, fair, and not misleading by, amongst other things, accurately describing the risks and impact, not disguising important information, fairly presenting alternative options, and taking into account the knowledge and expertise of the customers to whom the communication is to be made
- Ensure that client-facing staff are fully briefed and trained on the issues, and can respond to queries appropriately

Considerations for asset managers

The FCA's core expectation is that asset managers assess and manage their customers' exposure to LIBOR in a way that protects their customers' best interests.

Specifically, asset managers need to identify the extent of their customers' exposure and manage the associated risks, including engaging with issuers of LIBOR-referencing securities and derivatives, and with loan counterparties, to convert these instruments and products to alternative reference rates in good time before end-2021. Firms should have a plan in place for their investment strategy and best execution that considers the costs and implications of transition, and consider how they can deliver the plan in the best interests of customers.

Market preparedness

The FCA also published a speech, delivered by Edwin Schooling Latter, FCA Director of Markets and Wholesale Policy, on the next steps in the transition away from LIBOR. The speech outlined the progress made to date and the key next steps, including encouraging transition in sterling swaps and in loan markets, where progress has been slow thus far. Mr. Schooling Latter underscored that many of the arguments against transition have now faded, and that pressing on with movement away from LIBOR is likely to be the best course of action.

Mr. Schooling Latter also emphasised yet again that a time may come when LIBOR is no longer representative, but before contractual cessation triggers kick-in. He stressed that the inclusion of pre-cessation triggers in contractual documentation is the best way to prepare for the risk of LIBOR becoming unrepresentative, for products that have not moved away from LIBOR. With time moving fast, it is clear that there is still some way to go before the market is prepared for the end of LIBOR, and the FCA is keen to keep the issue at the top of firms' priority lists.

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