MEMO# 32063

November 26, 2019

FCA Publishes Q&A on Conduct Risk During LIBOR Transition

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November 26, 2019 TO: Chief Risk Officer Committee
Internal Audit Committee
International Internal Audit Advisory Committee RE: FCA Publishes Q&A on Conduct Risk During LIBOR Transition

As you may recall, in September 2019, the Financial Conduct Association (FCA) published a *Dear CEO LIBOR Letter*, which discussed the issues that UK registrants need to be considering in connection with the cessation of LIBOR.[1] To further condition registrants to the fact that LIBOR will end after 2021, last week, the FCA published *Conduct risk during LIBOR transition: Questions and answers.* This document expresses the FCA's expectation that "firms take appropriate steps to ensure they can transition to alternative rates ahead of end-2021."[2] According to the FCA, this publication, which is briefly summarized below, is intended to answer key questions on conduct risks arising from LIBOR.

The FCA's Expectations

The FCA makes clear that it expects registrants to (1) have a strategy in place and take necessary action during the LIBOR transition and (2) treat customers fairly by following the FCA's rules and guidance. The FCA expects its supervision of firms' transition efforts to be focused on "firms effectively managing the risks arising from transition, including prudential, operational and conduct risks." With respect to the Q&A portion of the FCA's publication, the FCA notes that it is not exhaustive and "firms will need to exercise judgement on the impact of LIBOR transition across their business, taking the interests of specific clients and the nature of the firm's business model into account."

Conduct risk during LIBOR transition

This portion of the document notes the wide range of financial products and types of firms that use LIBOR and, therefore, will be impacted by its cessation. It notes that the transition away from LIBOR may involve developing and offering new products tied to other reference rates and assessing and reducing exposure to legacy LIBOR contracts. Reducing exposure to legacy LIBOR contracts may involve amending or replacing existing contracts to either include a robust fall back provision and/or replace the LIBOR rate with another reference rate. Firms that invest on clients' behalf can avoid or manage the risks relating to LIBOR discontinuation by either: (1) investing in instrument linked to other reference rates; or (2) engaging with issuers of securities and derivative and loan counterparties linked to LIBOR to agree to another reference rate.

Governance and Accountability

This section of the FCA's publication poses the question, "What governance and accountability oversight should my firm put in place?" It answers this question by discussing the need for firms to have robust governance arrangements to manage business risks. Also, firms "need to consider whether any LIBOR-related risks are best addressed within existing conduct risk frameworks or whether, instead, a new, separate dedicated program is necessary." It reminds firms that they must act with due skill, care, and diligence and they must make and retain adequate records of their efforts.

Treating Customers Fairly When Replacing LIBOR

According to the FCA, its "overarching concern . . . will be whether firms have taken reasonable steps to treat customers fairly." As such, when replacing LIBOR with another reference rate, firms should avoid moving customers "with continuing contracts to replacement rates that are expected to be higher than what LIBOR would have been, or otherwise introduce inferior terms." The FCA cautions that it will "pay close attention" to such activities. The FCA also cautions that firms should (1) ensure they communicate effectively about the new rates or fallback positions; and (2) consider whether any contract term relied upon to amend a LIBOR-related product is fair under the Consumer Rights Act of 2015 (CRA). It further notes that "FG18/7: Fairness of variation terms in financial services consumer contracts under the CRA," contains "factors that firms should consider when thinking about fairness issues under the CRA when they draft and review unilateral variation terms in their consumer contracts."

Offering New Products with Risk Free Rates (RFRs) or Alternative Rates

The FCA poses the question, "Should I be offering new products that reference risk-free and other alternative rates rather than LIBOR-linked products?" It answers the question, "Yes." It goes on to discuss what firms should be doing and the issues they should consider in connection with LIBOR-linked products that mature after the end of 2021. It notes that, in derivatives and securities markets, "SONIA compounded in arrears is established as the preferred alternative reference rate" and, according to the RFR Working Group, "will and should become the industry standard in most parts of the bilateral and syndicated loan markets."[3] In the view of the FCA, "[i]t is essential that firms who continue to market, distribute and or sell LIBOR products that mature beyond end-2021 explain fully what will happen in the event of LIBOR ending and its effect on the customer." Firms should also:

- Consider offering alternative products that do not reference LIBOR;
- With respect to revising existing contracts referencing LIBOR, "communicate in good time to ensure customers can consider all the options available and respond before end-2021;"
- Engage with customers early on these issues;
- Plan for, and subsequently roll out, increased engagement with client-specific conversations in the run up to end-2021;
- Ensure that all client communications related to the LIBOR transition are "clear, fair, and not misleading;"
- Ensure client-facing staff have adequate knowledge and competence to understand the consequences of LIBOR ending so they can respond to client inquiries appropriately; and
- Ensure they have identified any product-specific obligations that may require taking

action in response to the LIBOR transition. As an example of this, the FCA notes that "fund managers should consider whether and how they need to engage with investors when replacing LIBOR references, including whether this amounts to a fundamental, significant, or notifiable change."

Asset Managers' Required Steps

The FCA's publication also discusses the steps asset managers will need to take. It recommends that they:

- Identify the extent of their and their clients' exposures to LIBOR as a result of LIBOR-referencing instruments in asset portfolios; and
- Consider how to manage the impact of the transition ahead of the end of 2021, including by engaging with issuers of LIBOR-referencing securities and derivatives and loan counterparties to convert these instruments and products to alternative reference rates (*e.g.,* through consent solicitation processes or bond buy-backs), "in good time before LIBOR's likely cessation."

The FCA's discussion of this issues concludes with the following:

Firms concerned about incurring costs, particularly those on behalf of customers should consider the likely increase in costs of dealing for LIBOR-linked products as the transition to SONIA-linked or alternative rate products progresses and liquidity in LIBOR products begins to diminish compared with alternatives. Firms should have a plan in place for their investment strategy and best execution that considers the costs and implications of transition to deliver in the best interests of customers.

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endnotes

[1] *See* https://www.fca.org.uk/news/statements/dear-ceo-libor-letter. See, *also,* the ICI's March 14, 2019 memorandum summarizing the FCA's Letter, which is available at https://www.ici.org/my_ici/memorandum/memo31652.

[2] This document is available on the FCA's website at: https://www.fca.org.uk/markets/libor/conduct-risk-during-libor-transition. The cover letter to the document is available at: https://www.fca.org.uk/news/statements/conduct-risk-during-libor-transition-questions-and-answers.

[3] Apparently the RFR Working Group has set a target date of the end of the third quarter of 2020 to stop new LIBOR cash contracts that mature beyond 2021. The FCA notes that it "supports this target date" and thinks that it will be "a key milestone for firms to meet to reduce their dependencies on LIBOR and potential harm to their customers." The FCA plans to monitor firms' progress on this milestone over the course of 2020.