UK FCA gives guidance on conduct risk during LIBOR transition

Following Andrew Bailey's speech in July 2017 that the UK Financial Conduct Authority (**FCA**) would, from the end of 2021, no longer be persuading or compelling banks to submit quotes to LIBOR (the London Interbank Offered Rate) and that market participants should therefore not rely on LIBOR being available after that date, the FCA expects firms to be taking appropriate steps to ensure they can transition to alternative risk-free reference rates (**RFRs**) before this.

Recently, in response to a letter from the Working Group on Sterling Risk-Free Reference Rates (**£RFR Working Group**), the FCA published some Q&As on conduct risk during LIBOR transition which set out its core expectations of firms during the transition away from LIBOR.

The FCA's supervision of firms' transition away from LIBOR is focused on firms effectively managing the risks arising from such transition, including prudential, operational and conduct risks.

Governance and accountability

Unsurprisingly, the FCA reiterates its previous messages that firms' senior managers and boards are expected to understand the risks associated with LIBOR transition and take appropriate action to move to alternative rates ahead of end-2021.

While firms are under general regulatory obligations to have effective processes and controls to identify, manage, monitor and report risks to their business, firms need to consider whether any LIBOR-related risks are best addressed within their existing conduct risk frameworks or, instead, need a separate, dedicated program. In many firms, LIBOR transition will impact the overall business and front-office client engagement; therefore, the potential impact and risks need to be considered and addressed in an appropriately coordinated way across the firm.

Firms that are subject to the senior managers and certification regime (**SMCR**) should allocate responsibility for overseeing the transition away from LIBOR to an identified Senior Manager. In addition, those responsibilities must be detailed in the relevant Senior Manager's Statement of Responsibilities.

While the Prudential Regulatory Authority (**PRA**) and the FCA have previously called for a Senior Manager in banks and insurers to be allocated this responsibility in Dear CEO letters last year, as the SMCR is being rolled out to FCA solo-regulated firms in December, these requirements will apply to all firms affected by LIBOR transition.

Should a firm not manage its move from LIBOR effectively, the FCA has clearly signaled that it may look to hold not only the firm, but also the relevant Senior Manager accountable.

Senior Managers should, therefore, act with due skill, care and diligence, and, among other things, keep detailed records of management meetings or committees as evidence of the steps they took to so act. They should also make sure that the governance arrangements, frameworks and processes which are put in place to ensure a smooth transition are clearly documented and are embedded in the firm's transition program.

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Treating customers fairly when replacing LIBOR with alternative rates

The FCA is particularly concerned that firms take reasonable steps to treat customers fairly when replacing LIBOR with alternative rates in existing contracts and products, considering the contract as a whole to ensure that the replacement rate is fair.

Firms must, therefore, not replace LIBOR in existing contracts with a rate or terms that would be less favorable to the customer. For consumer contracts, firms are expected to consider the Consumer Rights Act 2015 and the FCA's finalised guidance on the Act.

When transitioning existing contracts, the FCA states that firms should ensure that, among other things, LIBOR transition is not used to move customers with existing contracts to replacement rates that are expected to be higher than LIBOR would have been or otherwise introduce inferior terms.

Inserting new fall back provisions – where new fall back provisions are incorporated into existing contracts to replace LIBOR with a new reference rate, firms must ensure that customers receive effective communication on how these fall back provisions are expected to operate (such as whether the clauses operate at, or before cessation, and on what basis).

Adopting a replacement rate – the FCA states that: "firms are more likely to demonstrate that they have fulfilled their duty to treat customers fairly where they adopt a replacement rate that aligns with the established market consensus, reached through appropriate consultation, and is recognised by relevant national working groups as an appropriate solution" and refers in particular to the work both of the International Swaps and Derivatives Association, Inc. (**ISDA**) and the £RFR Working Group.

Although the FCA acknowledges that industry initiatives are still ongoing, so firms will ultimately have to exercise their own judgement on when and how to remove LIBOR dependencies in legacy contracts by end-2021, it reiterates its previous calls to the market that the "most effective way to avoid LIBOR-related exposure is not to write new LIBOR-referencing business, and to transition to alternative rates, taking into account the considerations on selecting a fair replacement rate."

Offering new products with RFRs or alternative rates

If a firm continues to offer LIBOR-linked products that mature after 2021, it must carefully consider whether these products can meet the needs of customers and continue to perform in line with their expectations both before and after the discontinuation of LIBOR.

It is essential any such firm explains fully to its customers what will happen in the event of LIBOR ending and the impact on them. LIBOR-linked contracts that include robust fall back provisions help reduce, but do not always eliminate, these risks.

SONIA and other RFRs

SONIA compounded in arrears is the preferred RFR for sterling LIBOR – the FCA notes that in the derivatives and securities markets, SONIA compounded in arrears is established as the preferred alternative reference rate to sterling LIBOR and that the £RFR Working Group is of the view that SONIA, compounded in arrears, will and should become the industry standard in most parts of the bilateral and syndicated loan markets.

Forward-looking SONIA term rate – the FCA says that a forward-looking SONIA term rate compiled from transactions in SONIA derivatives markets could form the basis of a fair replacement rate for legacy cash products and it may also be an

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option for new products in some circumstances but may not be the optimal choice. There may be other products (such as products based on SONIA compounded over an earlier period, fixed rates, or on "Bank Rate" as in some existing mortgages) that may be more appropriate for meeting the needs of customers who prefer cash flow certainty, which are likely to be more stable than forward-looking rates based on market transactions on a single day, and easier to explain and understand.

No more new sterling LIBOR cash contracts from end of Q3 2020 – the FCA supports this target date set by the £RFR Working Group and will monitor firms' progress on this during 2020. However, the FCA acknowledges that this will involve significant infrastructure and documentation preparation, customer communication and staff exercises for some banks.

Communicating with customers about LIBOR and alternative rates or products

The FCA stresses that, when communicating with customers about LIBOR transition, firms should keep in mind their overarching obligation to communicate information to customers in a way that is clear, fair and not misleading. For example, firms should clearly present the benefits, costs and risks of alternative rates and ensure that relevant information is not disguised or hidden.

Firms should ensure that customers:

- have information about alternatives to legacy products in good time so as to make informed decisions about relevant products and risks; and
- are kept appropriately informed about the impact of LIBOR cessation on existing and new financial products and services.

Some customers may not fully understand the implications of alternative products so any communications should be tailored in light of the knowledge and experience of the intended audience. Staff may need additional training to ensure they can communicate effectively to customers and answer any queries competently.

The FCA offers comfort to firms indicating that it is possible to provide an objective overview of the benefits, costs and risks of a range of alternatives to a client's existing LIBOR-linked exposure, without offering a personal recommendation. However, in order to keep on the right side of regulation in this respect, it is important that firms ensure that their staff fully understand the boundary between providing information and advice.

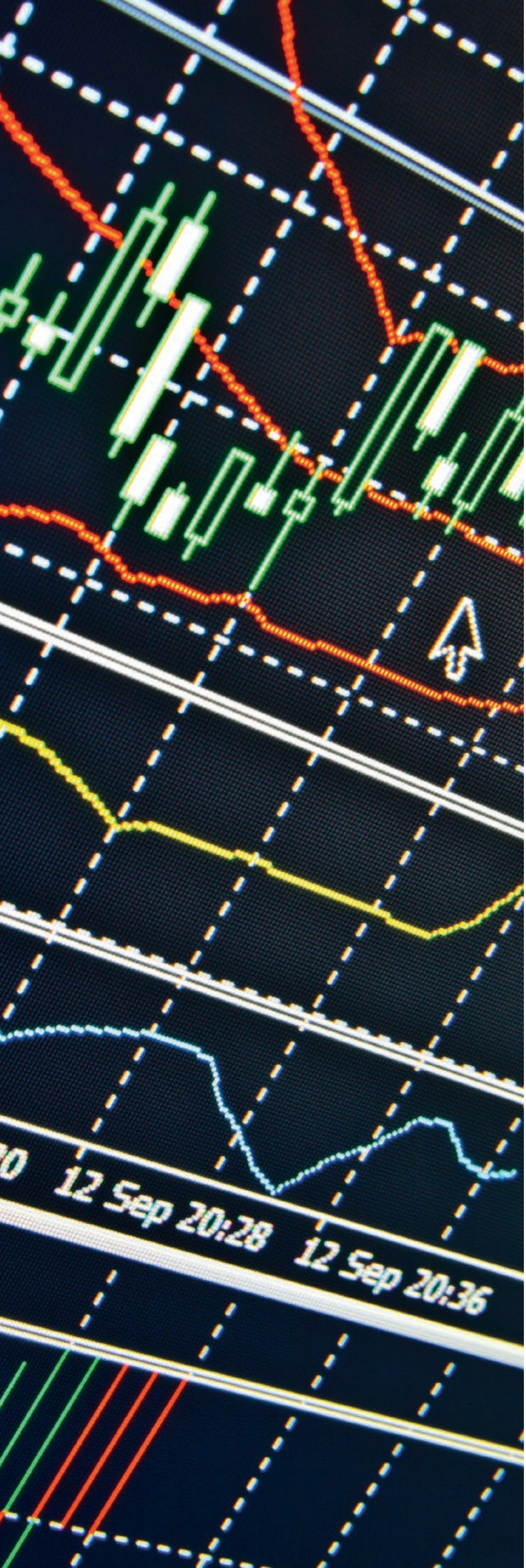
The FCA advises firms to engage with customers early to raise awareness and educate them on the general implications and timing of LIBOR transition for both existing and new contracts.

The FCA will challenge firms if:

- contracts contain small print which result in higher costs for customers (for example, by replacing LIBOR with a higher rate);
- customers are left with insufficient time to understand the options and make informed decisions; or
- customers are not provided with an objective overview of benefits, costs and risks of a range of alternative products to customers.

Firms investing on customers' behalf

The FCA stresses that it expects "buy-side" firms, such as asset managers, also to prepare for LIBOR transition. In particular, firms should have a plan in place for their investment strategy and best execution that considers the costs and implications of LIBOR transition to deliver in the best interests of customers.



What do you need to do now?

By publishing Q&As on conduct risk during LIBOR transition and relying on the SMCR to allocate a Senior Manager responsible for LIBOR transitioning, the FCA is clearly putting firms on notice that it will challenge them if they fail to meet these standards. The FCA will also hold individuals accountable where appropriate.

Firms that have not already done so should draw up their LIBOR transition plans now. As the FCA has highlighted, given that LIBOR transition will impact a firm's overall business, any transition plans should be considered and addressed in an appropriately coordinated way across the firm.

Next steps

We recognize that transitioning legacy LIBOR contracts to new RFRs is an immensely complex task, particularly in light of the many uncertainties still outstanding. A successful repapering exercise requires a precise understanding of the legal issues and the practical realities of the transition to the new RFRs across different currencies and financial products.

We have developed a "one-stop shop" solution to support clients with the discontinuation of LIBOR after 2021 with an advanced delivery toolkit to provide legal expertise using alternative legal resourcing through Hogan Lovells' Legal Delivery Center, Cognia Law and AI technology through our partnership with FTI Consulting.

More information on our advanced digital solution for LIBOR replacement [is available here](#).

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