IBOR transition

Know your conduct risks

April 2019
If the reason you are not acting is because you think we are going to change course, I'm afraid you are wrong. You need to be prepared for an end date for LIBOR in 2021. Whether your exposure is to sterling LIBOR or one of the other LIBOR rates, you will hear the same message from central banks and regulators in other jurisdictions, as you hear from FCA and the Bank of England.

Source: Speech by Megan Butler, Executive Director of Supervision – Investment, Wholesale and Specialists at the FCA (February 2019)

Senior managers and boards of the largest firms are expected to “understand the risks associated with this transition and are taking appropriate action now so that your firm can transition to alternative rates ahead of end-2021.”

Source: Dear CEO Letter, Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA)(September 2018)
Interbank Offered Rates (IBOR) have been a cornerstone of the financial markets for decades. They have played an important part in setting payment schedules for loans and mortgages, pricing of derivatives and acting as a benchmark for numerous financial products. However, as a result of declining market liquidity in the interbank markets following abuse of the rate over numerous years, regulators from across the globe have made it clear that the reliance on such a benchmark is to cease.

To assist firms with their plans, this paper aims to highlight the key conduct risks that firms need to be aware of through the transition process, and identifies areas of prioritization for 2019 to the end of 2021.

Recent communication from regulators, including the “Dear CEO” letter from the FCA, should be seen by firms as a “starting gun” for the assessment of conduct risks. This call to action for firms can be summarized as follows for conduct risk to be addressed on a “no regrets” basis:

- **Continuing to sell IBOR products**: Firms should identify now the conduct risks of continuing to sell to clients IBOR-referenced products with a maturity beyond 2021 and decide when to discontinue the sale of these products.

- **Effective communication with front-book and back-book clients**: There is a conduct risk of clients receiving inadequate, unclear or untimely information. Firms should now be disclosing the discontinuance of IBOR to front-book clients. Back-book clients should similarly be put on notice as to IBOR discontinuance, taking into account the prioritization of different client cohorts. Additionally, a strategy should be developed with a timeline for communicating specific impacts to client cohorts.

- **Pro-active contract review**: Firms should now be identifying all relevant contracts and determining the key data attributes that will impact client outcomes. Firms should also consider whether existing fallback language is fit for purpose given the discontinuance of IBOR. Even where firms do choose to amend existing language, if the fallback were triggered, firms still need to assess whether the subsequent value transfer (including changes in margin and spread) could still lead to client detriment. Therefore, firms should not place reliance on fallback terms, which were intended to be used in temporary situations, and repapering of contracts should be considered.

- **Industrialized product governance**: The IBOR transition should be regarded by firms as a “crucial event” in relation to product governance. Therefore, firms should review their processes for migration of clients and the associated governance for each product type. Additionally, firms should consider industrializing their governance processes due to the potential volume of new and transitional products arising through IBOR transition.

- **Enhanced sales process**: Firms should review their sales process to avoid the conduct risk of clients not receiving a fair outcome through the transition from IBOR to RFR product or suitable alternative. Firms should now consider revising supporting documentation and the re-evaluate the dividing line between non-advised and advised sales.

All of the above issues should consider the different impacts of each client cohort, taking into account their sophistication and product complexity. Clients with lower levels of sophistication should be focus areas for firms when developing products and enhancing sales processes. The output of any assessment should be able to demonstrate that all clients have been treated fairly and risk mitigated through enhanced controls.
As firms establish and implement their IBOR programs, the following key questions are critical to establish program priorities and determine next actions

1. Can I assume IBOR will continue after 2021?

The FCA has stated “You need to be prepared for an end date for LIBOR in 2021. Whether your exposure is to sterling LIBOR or one of the other LIBOR rates, you will hear the same message from central banks and regulators in other jurisdictions, as you hear from FCA and the Bank of England”

Additionally the US Commodity Futures Trading Commission (CFTC) has stated: “The discontinuation of the London Interbank Offered Rate (LIBOR) is not a possibility. It is a certainty. We must anticipate it, we must accommodate it and we must adapt to it.”

2. Will firms be required to carry out conduct risk assessments?

The FCA in its Dear CEO letter expects the largest firms to undertake a comprehensive risk assessment of conduct impacts associated with IBOR transition in a range of different scenarios.

The Swiss regulator FINMA has also issued an IBOR transition self-assessment questionnaire, which includes a request on whether a comprehensive impact assessment (including fallback options) has been performed on reputational and conduct risks. The self-assessment has been circulated to a wide number of firms (to smaller firms as well as the large firms) demonstrating the broad scope of the IBOR transition.

3. Does my IBOR transition program need to be flexible to cope with accelerated timelines?

The FCA has noted: “So, it is entirely plausible that the end-game for LIBOR will include an assessment by the FCA that one or more panels have shrunk so significantly in terms of number of firms or the market share of the firms remaining, that it no longer considers the relevant rate capable of being representative. The FCA would announce such a view if and when it is reached. Market participants would then need to consider the many potential negative ramifications of using a rate when its regulator had found it not to be reliably representative of the underlying market.”

4. Can I rely on the wording within my fallback clauses for the IBOR transition program?

With regards to fallback clauses and their use throughout the transition, the FCA has commented “Fallbacks are not designed as, and should not be relied upon, as the primary mechanism for transition. The wise driver steers a course to avoid a crash rather than relying on a seatbelt”

The FCA has also highlighted “We think that the best and smoothest transition from LIBOR will be one in which contracts that reference LIBOR are replaced or amended before fallback provisions are triggered.”
The following themes will help firms review and assess conduct risks in a structured way, as part of the lifecycle of an IBOR transition program.

**Communications**
Risks: Unclear, untimely or misleading information (taking into account client needs) on the material changes for their products, which are affected by the IBOR transition.

**Product governance**
Risks: Approval of a new RFR product does not consider the client outcome of transition from an IBOR product, or failure to review the continuance of an IBOR product.

**Contract terms**
Risks: Reliance on contract terms (or non-existent contract terms), which impact on clients’ ability to achieve a fair outcome from IBOR transition.

**Sales process**
Risks: Failure of sales process relating to transition to RFR or alternative product including: suitability and appropriateness assessment, product information and disclosures.

**Conflicts of interest**
Risks: Processes do not identify and manage any conflicts of interest from transitioning to RFR product compared to a suitable alternative.

**Market conduct**
Risks: Inadequate policies and controls in place to prevent market abuse from transitioning large portfolios from IBOR product to RFR or alternative product.

The challenge is to balance the competing objectives of providing customers with early sight of their options, whilst allowing product offerings to mature. A targeted conduct risk assessment, will enable firms to plan an approach which can effectively manage these objectives.

-Stuart Crotaz (Partner, EY)
Through the front-to-back process of transitioning clients out of their IBOR products and developing new products, conduct issues may arise. The table below sets out the key conduct themes during the lifecycle of IBOR transition and the mitigating actions to be taken to address the potential scenarios that firms will wish to avoid.

### Conduct risk can arise from poorly executing the client transition to post-IBOR products

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<th>Theme</th>
<th>Key considerations</th>
<th>Outcomes</th>
<th>Mitigating actions</th>
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| **Communications**         | • Have back book clients been sent a "general" communication to put them on notice regarding IBOR transition?  
• Have front book clients been disclosed information relating to the discontinuation of IBOR, including alternative products?  
• When do you intend to send tailored communications to client cohorts?  | • Clients receive timely information and understand the IBOR transition process and proposed timeframes.  
• Clients are made aware of the material changes to their products and impacts arising from IBOR transition.  
• Firms obtain all requisite client consent to transition products to the new post-IBOR rate.  | • Distribute a disclosure to all clients (front and back book) to put them on notice in relation to future potential changes.  
• Develop a detailed communication strategy with periodic and tailored communication with clients taking account of their sophistication and complexity of product, and whether they are front book or back book clients.  
• Identify and validate the level of consent that will be required per product and client base on new terms, conditions or rates.  |
| **Product governance**     | • Have you determined the indicative dates for when you will stop selling IBOR products and the mechanism to monitor this?  
• Has the current product governance process been updated to consider the conduct impact of the transition to a RFR product from an IBOR product?  
• Is your current product governance capable of dealing with the volume of new RFR products with IBOR transition?  | • Existing IBOR products are discontinued at an appropriate time.  
• The transition to new RFR products does not cause detriment to clients.  
• Effective and robust product governance for IBOR transition.  | • Product governance process captures timely review of existing IBOR products to determine dates to stop selling these.  
• Update the product governance process for transition from IBOR products. Firms should assess product complexity, client sophistication and transfer in value (including margin and spread).  
• Industrialize the product governance process for new RFR and for transition of products to cope with expected volumes.  |
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<td>Contract terms</td>
<td>• Have you determined timeframes for reviewing and renegotiating contracts?</td>
<td>• Contracts do not have clauses which would lead to an unfair outcome for clients from IBOR transition.</td>
<td>• Implementing a contract repapering strategy which provides a fair outcome for clients, taking into account transfer in value.</td>
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<td>• Are you intending to enforce break clauses if the client does not agree to the transition RFR product offered to them?</td>
<td>• Firms do not enforce break clauses which would lead to an unfair outcome for clients from IBOR transition.</td>
<td>• Firms need to identify IBOR related contract provisions and associated client cohorts and assess their impact on IBOR transition.</td>
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<td>• Have you determined whether your firm will rely on existing or updated fallback language?</td>
<td>• If a fallback clause is triggered the transfer in value does lead to an unfair outcome for clients.</td>
<td>• Firms should review existing and amended fallback clauses to assess the impact on clients.</td>
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<td>Sales process</td>
<td>• Have current sales processes for front book clients been updated to reflect the disclosure requirements where you are continuing to sell IBOR products?</td>
<td>• Repayment rates for new products are equivalent to IBOR product or other suitable alternatives.</td>
<td>• Review current sales processes and supporting documentation to ensure that they mitigate the risks relating to IBOR transition. This review should consider:</td>
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<td>• Does the current sales process deal with an assessment of suitability or appropriateness for transitioning products for back book clients?</td>
<td>• The new product offered as part of transition meets individual client’s needs and where required provides the same hedging protection.</td>
<td>• Where RFR or alternative products are offered, sales teams to have certainty that they will not cause detriment to the client.</td>
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<td>• Have the sales teams been provided with training on IBOR transition?</td>
<td>• Sales teams understand the IBOR transition process and the new products to be offered by type and client sophistication.</td>
<td>• IBOR transition suitability or appropriateness assessments.</td>
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<td>• Identify situations where non-advised sales could become an advised sale and where necessary develop additional sales process controls and documentation.</td>
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Transitioning to a post-IBOR world

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<td>Conflicts of interest</td>
<td>* Have you identified potential conflicts of interests arising from the IBOR transition sales process?</td>
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<td>* Have you considered whether your transitioning to RFR products would have an impact on revenue and margin?</td>
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<td>* Will additional controls be in place should conflicts arise from the transition?</td>
<td>* Any conflicts of interest are effectively managed through controls.</td>
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<td>* Sales teams are not incentivized to achieve sales targets by selecting a RFR product compared to a suitable alternative.</td>
<td>* Firms need to review and identify any conflicts that could arise within the sales process, revenues and margins, and assess how these can be controlled.</td>
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<td>* Any conflicts of interest are effectively managed through controls.</td>
<td>* Traders are not able to benefit from a shift in pricing (by front-running) where large portfolios are transitioned out of an IBOR linked product onto a RFR product.</td>
<td>* Review all applicable sales and trading controls to identify if additional preventative and detective market abuse controls or updates to existing controls are required.</td>
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| Market conduct                | * Have you identified potential market conduct issues arising from the IBOR transition?  | * Policies, procedures and controls are in place to prevent market abuse arising from IBOR transition.  |
|                               | * Has any training for sales and trading included market conduct in relation to the IBOR transition?  | * Traders are not able to benefit from a shift in pricing (by front-running) where large portfolios are transitioned out of an IBOR linked product onto a RFR product.  | * Develop targeted IBOR transition sales and trading training which focuses on market conduct issues.  |
|                               | * Are you intending to put additional Front Office controls in place relating to Market Conduct and IBOR transition?  | * Re-assess current market surveillance scenarios to ensure that they are able to identify behaviors and/or patterns of activity relating to IBOR transition.  |
**Wholesale**

**Firms issuing interest rate swaps linked to IBOR**

Firms that continue to issue interest rate swaps linked to IBOR may find themselves facing conduct issues in the future. As firms know that IBOR will be discontinued and that swaps referencing it will have to be amended, firms will need to consider additional factors to ensure that all clients have been managed with due skill, care and diligence.

RFR rates are not equivalent to IBOR rates. Therefore, firms should consider the economic transfer in value of transitioning the client (including changes in margin and spread) in order to assess if there is any conduct risk and whether an alternative non-RFR rate should be offered.

Break costs should not be charged to transition a client to a new RFR swap. Firms will need to consider the appropriateness of the new RFR swap especially for retail and SME (small and medium enterprise) clients, and whether an alternative non-RFR product is more appropriate. Additionally, firms should consider whether the RFR swap will provide the same level of hedging protection as the IBOR swap.

Furthermore, firms will have to make sure that they communicate any rate changes to all impacted clients, also obtaining their consent to any change in terms.

Firms must also make sure that their traders are not front-running transitioning of clients out of IBOR positions to new RFR swaps.

**Retail**

**Mortgage and loans repayment rates**

Clients that have mortgages and loans linked to IBOR may find that their cash outflows change when their products move to a new RFR mortgage. Firms will have to clearly communicate and educate their clients on what the rate changes mean for their repayments. Failure to do so may find firms receiving complaints from clients that their rate of repayment has changed without their consent or knowledge.

Firms should not be seen to be increasing their revenues by raising the repayment rates of their clients. Any conflicts of interest between treating their clients fairly and increasing revenues will have to be managed. Firms will have to identify those mortgage clients that have been affected, including those where legacy backbook customers have been acquired from another firm. Firms will clearly have to show how they chose an appropriate RFR or alternative product to transition their client’s mortgages to, and keep evidence of supporting documentation provided.
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