FMSB
FICC MARKETS STANDARDS BOARD

Spotlight Review

LIBOR transition
Case studies for navigating conduct risks

June 2020

About FMSB

FICC Markets Standards Board Limited (FMSB) is a private sector, market-led organisation created as a result of the recommendations in the Fair and Effective Markets Review (FEMR) Final Report in 2015. One of the central recommendations of FEMR was that participants in the wholesale fixed income, currencies and commodities (FICC) markets should take more responsibility for raising standards of behaviour and improving the quality, clarity and market-wide understanding of FICC trading practices. Producing guidelines, practical case studies and other materials that promote the delivery of transparent, fair and effective trading practices will help increase trust in wholesale FICC markets.

FMSB brings together people at the most senior levels from a broad cross-section of global and domestic market participants and end-users.

In specialist committees, sub-committees and working groups, industry experts debate issues and develop FMSB Standards and Statements of Good Practice, and undertake Spotlight Reviews that are made available to the global community of FICC market participants and regulatory authorities.

Spotlight Reviews

Spotlight Reviews encompass a broad range of publications used by FMSB to illuminate important emerging issues in FICC markets. Drawing on the insight of members and industry experts, they provide a way for FMSB to surface challenges market participants face and may inform topics for future work. Spotlight Reviews will often include references to existing law, regulation and business practices. However, they do not set or define any new precedents or standards of business practice applicable to market participants.

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LIBOR transition

Significant steps have been taken by financial market participants and regulators since 2012 to strengthen the governance, transparency and reliability of LIBOR benchmarks. However, as set out in the Financial Stability Board's (FSB) 2014 report[1], and subsequently reiterated by regulators around the world, the post-financial crisis decline in liquidity in interbank unsecured funding markets has rendered such markets an unsustainable reference source and therefore alternative reference rates are necessary to underpin robust and effective markets.

National working groups have since been established to implement the FSB's recommendation to develop alternative risk-free rates (RFRs). In the UK the Working Group on Sterling Risk-Free Reference Rates (RFR Working Group) has recommended the Sterling Overnight Index Average (SONIA) benchmark as its preferred RFR, and in the US the Alternative Reference Rates Committee (ARRC) has selected the Secured Overnight Financing Rate (SOFR) as the rate that represents best practice for use in certain new USD derivatives and other financial contracts. As the risks associated with the continued provision of new LIBOR-linked products increase, RFRs, such as SONIA and SOFR, will be an important foundation for delivering fairer and more effective markets that lie at the heart of FMSB's mission. However, a smooth transition from LIBOR to RFRs relies upon the effective mitigation of certain conduct risks.

This Spotlight Review

This paper examines risks to market fairness and effectiveness that may arise during the transition and considers how market participants might address these risks. In particular, it aims to highlight how uncertainties, for example relating to the future performance of RFRs and LIBOR, liquidity in RFR products and evolving industry conventions, present decision-making challenges for market participants when offering new products to clients or changing performance benchmarks. The Spotlight Review seeks to illuminate these uncertainties through practical case studies. Building on existing FMSB principles, relevant regulatory expectations and the expertise of FMSB's IBOR Transition Working Group participants, this paper explores ways in which firms can manage the uncertainties and associated risks of the transition through the lens of non-prescriptive good practice observations.

The purpose of this Spotlight Review is to support market participants as they plan for and manage the transition away from LIBOR to more sustainable and representative benchmarks and thereby promote fair and effective markets.

The Spotlight Review will be of interest to market participants across the sell-side, buy-side and corporates, and could be used to help inform the identification and management of certain LIBOR transition-related risks. However, this document is not intended to serve as legal advice, or as a substitute for firms' conduct obligations when offering products linked to LIBOR or alternative rates.

We intend to add to this Spotlight Review during the transition to include additional case studies focusing on areas of uncertainty and risk that are of particular concern to market participants.

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Background

On 27 July 2017, the Chief Executive of the UK Financial Conduct Authority (FCA) announced that the FCA did not intend to persuade or compel banks to submit rates for the calculation of LIBOR after 2021. Since then, regulators, national working groups and market participants have focused on how the market can transition away from LIBOR to alternative RFRs within this timeframe. The FCA has also reiterated that, despite the challenges to market participants posed by the coronavirus pandemic, "it remains the central assumption that firms cannot rely on LIBOR being published after the end of 2021"[2]. Nonetheless, it has been recommended by the RFR Working Group that certain interim transition milestones be extended in light of the operating environment resulting from the coronavirus pandemic.

Transition to more effective and robust markets

The transition away from LIBOR to alternative RFRs should promote more robust and effective markets. In particular, as the Bank of England has noted[3]:

- short-term wholesale deposit markets are no longer sufficiently active to form the basis for a robust transaction-based benchmark. LIBOR is therefore overly reliant on expert judgement rather than actual transactions;
- RFRs are better reflections of the general level of interest rates as they do not price in fluctuations in the perceived credit quality of banks. Interest rates should therefore be less volatile, notably in times of stress; and
- RFRs, such as SONIA, represent conditions in a deep underlying market and the data inputs can evolve over time to ensure the design of such benchmarks is robust to future changes in the money markets.

In its Interim Financial Stability Report published in May 2020[4], the Bank of England emphasised, in light of recent market volatility, the continued importance of the transition away from LIBOR.

FMSB members recognise the importance of transition in light of the weaknesses of LIBOR benchmarks set out above but also recognise that the transition is complex. The actions of market participants during, and in managing, the transition could impact the effectiveness of the derivatives, loans and bonds markets. Uncertainties associated with the transition may make it harder for firms to identify how to treat their customers fairly, and to demonstrate that they have done so. Moreover, it is important to note that adverse client or market outcomes may arise through no fault of the market participant.

In highlighting these uncertainties, and the steps that market participants could take to manage such uncertainties, this Spotlight Review can help support a fair and effective transition from LIBOR benchmarks.

Structure

This Spotlight Review is divided into two sections:

- 'FMSB principles and regulatory expectations' considers how existing FMSB Standards and Statements of Good Practice (collectively referred to as 'FMSB principles') and relevant regulatory expectations, can help inform how market participants manage the uncertainties and associated risks that LIBOR transition may give rise to; and
- 'Case studies' illustrates, using practical examples focusing on the issuance or sale of new RFR-linked products and buy-side risks, where uncertainties and associated risks to market fairness or effectiveness could arise during the transition, and considers the ways in which market participants could seek to manage these risks in a manner that promotes fair and effective markets.

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Putting LIBOR conduct risks in context

The scale of the business, operational and contractual implications of LIBOR transition present market participants with unique challenges. However, many of the conduct-related risks that firms face, and the means of managing such risks, are not novel. This section therefore considers how the application of existing FMSB principles can inform the management of risks arising from this transition. These existing FMSB principles are shown alongside relevant regulatory commentary issued by both UK and US regulators in various forms specifically in the context of LIBOR transition. However, the FMSB principles quoted in this section do not impose any additional obligations on firms in the context of LIBOR transition. Rather, they provide a useful means of approaching these risks in a manner consistent with other conduct risks that market participants manage.

This section is divided into six themes relevant to managing risks to the fairness and effectiveness of markets during the transition:

- i risk identification;
- ii governance;
- iii communicating with customers;
- iv conflicts of interest;
- v treating customers fairly; and
- vi market conduct.

These themes, and the associated regulatory expectations, are not intended to be exhaustive and market participants will need to identify the risks of LIBOR transition and potential mitigation strategies in accordance with their own exposures and business.

i Risk identification

FMSB principles	Regulatory expectations
"Firms should have a taxonomy for the identification and assessment of common conduct risks that may occur in market transactions and that are relevant to their business."[5] "Firms should… assess the nature and impact of new conduct events to ensure that existing taxonomies continue to cover known behaviours."[6] **Commentary** – Firms already have in place taxonomies which identify conduct risks that can occur in market transactions. Consideration could therefore be given as to how conduct risks arising during LIBOR transition fit within these existing taxonomies and whether any new behaviours emerge.	Regulatory commentary has focused on: **Identifying and managing risks** – Firms should have effective processes and controls to identify, manage, monitor and report risks to their business. Firms should take appropriate steps to protect their clients, the firm and the markets.[7] **Conducting impact assessments** – Adopting a holistic approach to assessing the impact of LIBOR discontinuation, that extends beyond identification, evaluation, and mitigation efforts related to existing or new contracts and also considers the consequences of LIBOR discontinuation on business strategy, products, processes, and information systems.[8] **Considering sufficiency of existing conduct risk frameworks** – Firms need to consider whether any LIBOR-related risks are best addressed within existing conduct risk frameworks or need a separate, dedicated programme.[9]

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Governance

FMSB principles	Regulatory expectations
"Firms should develop management information based on their conduct risk taxonomies that allows governance fora and senior management to consider and challenge the conduct risks identified in the market transactions of the firms."[10] "Firms should ensure that the output of their risk identification and assessment process informs the developments of policies and procedures that are sufficiently detailed to address the identified risks."[11] **Commentary** – The outputs of the risk identification and assessment processes could inform the decision making of governance fora and senior management when making decisions as to the firm's strategy of managing conduct risks arising from LIBOR transition.	Key governance themes deriving from regulatory commentary include: **Board level understanding of risks** – 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 the end of 2021. Notably, for firms that are subject to the UK Senior Managers and Certification Regime this involves, where relevant, identifying a Senior Manager responsible for overseeing transition away from LIBOR and detailing those responsibilities in the relevant Senior Manager's Statement of Responsibilities.[12] **Robustness of governance arrangements** – Firms should ensure they have robust governance arrangements in place for managing risks in their business.[13] **Record keeping** – Firms should keep 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.[14] **Systems changes** – Transition will need to occur not only in financial contracts but also in the systems and policies that reference LIBOR.[15] **Product governance** – Firms need to consider the design and risks of any new LIBOR-referencing instruments as part of their product governance obligations. This should include considering and describing the impact of LIBOR discontinuation on those instruments. Firms will also need to provide appropriate information to all distributors of those financial instruments.[16]

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Communicating with customers

FMSB principles	Regulatory expectations
"Market participants should communicate in a manner that is clear, accurate, professional and not misleading."[17] **Commentary** – In addition to this principle, when communicating information to customers regarding the risks associated with LIBOR cessation, firms should consider whether such communications can be easily understood by their intended recipient. However, uncertainties as to what will happen on LIBOR cessation and how fall backs will behave presents challenges for firms when seeking to identify and communicate these risks.	Key themes when communicating with customers include: **Ensuring timely disclosures** – Information should be presented in good time to allow customers to make informed decisions about relevant products and the risks that customers may be exposed to. **Comprehensive disclosures** – Firms should disclose comprehensive and accurate information about the risks and explain fully what will happen in the event of LIBOR ending and its effects on the customer.[18] **Discussing product options** – Expectation that banks discuss products (including loans) that do not rely on LIBOR with customers and explain the potential risks of continuing with LIBOR.[19] **Internal and external communication strategies** – Developing and executing comprehensive internal and external communication strategies to promote education on transition among key stakeholders.[20] **Objective overview of alternative products** – Firms should not avoid presenting or discussing alternative products due to concerns of straying into personal recommendations. 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 a recommendation.[21]

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iv Conflicts of interest

FMSB principles	Regulatory expectations
"Firms should take appropriate measures to identify conflicts of interest between the firm and a client, between clients, or between the firm's employees and the firm and/or a client."[22] "Firms should ensure they have effective measures (including appropriate governance) in place designed to prevent or appropriately manage and mitigate those conflicts of interest that have been identified and/or which may arise from time to time."[23] **Commentary** – LIBOR transition may give rise to new, or accentuate existing, conflicts of interest between firms and their clients where there is a divergence of interests, duties or responsibilities between the parties, for example when handling value transfers that result from the operation of fall back provisions or voluntary transition or where firms have discretion around the operation of contractual fall backs. Where this is the case, consistent with existing FMSB principles, firms should consider the measures they need to take to manage these new or accentuated conflicts.	In this context, regulatory commentary has highlighted the need for firms to: **Identify conflicts of interest** – Firms should consider a range of conduct risks, including the potential for conflicts of interest to arise and the requirement on firms to identify and prevent or manage such conflicts of interest where they do arise.[24] **Mitigate conflicts of interest** – Any conflicts of interest arising from LIBOR transition must be mitigated or, where that is not possible, managed appropriately.[25] **Benchmark performance** – The FCA has identified a specific example of where conflicts could arise as being where fund managers change performance benchmarks and ensuring that these changes do not misrepresent performance.[26]

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Treating customers fairly

FMSB principles	Regulatory expectations
Existing FMSB principles are not directly relevant when considering what this expectation means for firms.	For existing LIBOR-linked products that mature beyond the end of 2021, this commentary has focused on: **Fall backs** – Firms inserting robust fall back provisions in existing contracts to take effect before, or at the time of, LIBOR cessation or converting the contract to reference an alternative rate. The aim being to ensure that the product continues to operate effectively.[27] **Replacement rates** – Where customers move to replacement rates, such rates should not be expected to be higher than what LIBOR would have been or otherwise result in the introduction of inferior terms. When selecting replacement rates, firms are more likely to be able to demonstrate that they have treated customers fairly where they use replacement rates that align with established market consensus, reached through appropriate consultation, and are recognised by relevant national working groups. **LIBOR-SONIA spread** – Firms receiving LIBOR-linked interest are not expected to give up the difference between LIBOR and SONIA that results from the term credit risk premium.[28] **Firms investing on behalf of customers** – Firms should work to manage their customers' exposure to LIBOR in a way that protects their customers' best interests. For new contracts, the FCA has emphasised that: **Customer needs** – The conduct risks of striking new LIBOR-referencing transactions that mature after the end of 2021 are rising. Where firms continue to offer long-dated LIBOR-linked products they will need to consider carefully whether these products meet the needs of customers and continue to perform as customers are led to expect prior to and following LIBOR discontinuation.[29]

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Market conduct

FMSB principles	Regulatory expectations
"Market participants should clearly and effectively identify and appropriately limit access to confidential information."[30] "Firms should ensure that the output of their risk identification and assessment process informs the development of monitoring and surveillance to address the identified risks."[31] "Member firms should have a clear organizational structure for delivering a risk-based program of conduct training that is appropriate to their firm, taking into account their business model, scale and complexity..."[32] **Commentary** – Managing risks associated with market misconduct or inappropriate disclosures of confidential information forms part of business-as-usual risk management for market participants. However, LIBOR transition may create new cases of misconduct. Firms may consider delivering conduct training on the risks associated with LIBOR transition. This could involve the use of case studies to translate the high-level regulatory expectations into actionable guidance for employees.	Regulatory commentary in this context has focused on: **Acknowledging a range of potential risks** – Market participants should give consideration to potential risks of market manipulation or insider trading and where necessary enhancing surveillance and awareness of traders and second line staff.[33] **Contributing to benchmarks** – Firms should consider the potential risks associated with contributing to LIBOR benchmarks, including in potentially less liquid markets.[34]

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Topic 1: Sale or issuance of new products

Given the imminent discontinuation of LIBOR and rising conduct risks associated with striking new LIBOR-referencing transactions, market participants are increasingly transitioning to alternative RFRs for new business. Avoiding new LIBOR-related exposures should facilitate a smoother transition. However, while LIBOR-based products are very mature, some of the products referencing alternative rates are still in the early stages of development, with limited liquidity and evolving conventions. Products will likely continue to evolve in the future. For example, market conventions for RFR interest calculations could change or forward-looking term rates related to the alternative rates could become available. Furthermore, as illustrated by the coronavirus pandemic, future reference rate levels are uncertain.

This creates several risks for banks offering alternative products as well as corporates, buy-side, and other end-users of the new products.

Notably, market participants may:

- not understand how a product based on an alternative rate will behave;
- not be operationally ready to use products based on alternative rates;
- believe that they would have been better off continuing to use LIBOR in the near-term, for several reasons, including:
  - lower interest payments on cash products (if the LIBOR-RFR spread narrows below any adjustment that is made to the interest margin);
  - change in relative value of derivatives if the LIBOR-RFR spread moves adversely in the future;
  - allowing more time to change systems and processes;
  - awaiting greater clarity on standard industry conventions;
  - in anticipation of the availability of alternative products in the future (e.g. using forward-looking term rates); and/or
  - aligning with existing portfolios or instruments to be hedged that are currently linked to LIBOR.

These risks are illustrated in:

Case Study A	Bilateral or syndicated corporate sterling borrowing through a SONIA-based, or Bank of England base rate, loan.
Case Study B	Corporate sterling borrowing through a SONIA-based loan and simultaneously entering into an interest rate swap to fix the interest payments.
Case Study C	Corporate entering into a USD LIBOR-SONIA swap to hedge exposure arising from GBP loan and USD investment.

The scale and nature of these risks, and how they can be managed, will depend on the service being provided, the nature of the relationship between market participants (e.g. the bank and its clients), the complexity of the relevant product and the sophistication of the market participants. As such, the good practice observations will need to be tailored accordingly. Furthermore, the risks to market fairness and effectiveness as well as the corresponding good practice observations set out in this section are not intended to be exhaustive and firms will need to consider these risks in accordance with their own exposures and business.

A number of the good practice observations are likely to be common across the different case studies. These are set out below and could also be used to inform the management of risks associated with new loans denominated in USD or other currencies also transitioning from LIBOR to an RFR.

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Good practice observations applicable to Case Studies A, B and C

Bank perspective

Communicating with customers

To address the communication issues identifed in 'FMSB principles and regulatory expectations' above, the bank communicates appropriately with clients throughout the process, including:

- **Background information on LIBOR transition** – Providing background information on the need for, and status of, transition away from LIBOR to alternative rates such as SONIA.
- **Understanding of client needs and situation** – Depending on the circumstances (e.g. client size and sophistication, type of product and nature of the business relationship between the bank and its client), it may be appropriate for the bank to discuss with the client first to understand its financing or hedging needs, particularly in terms of timing and duration, given the likely discontinuation of LIBOR at the end of 2021. It may also be appropriate for the bank to discuss the client's awareness of SONIA as an alternative to LIBOR and its operational capabilities to process products based on SONIA.
- **Product options and pros/cons** – The bank may provide information on product options, which could include floating rate loans based on SONIA compounded in arrears, Bank of England base rate, fixed rate loan options as well as, where the bank deems appropriate, LIBOR (with robust fall back language and/or clear contractual arrangements to facilitate conversion ahead of the end of 2021). In addition, it may be appropriate to provide an objective overview of the relative pros and cons of different product options (including different behaviour of alternative rates compared to LIBOR), as well as operational implications (particularly for the SONIA compounded in arrears option). The bank may also seek to make the client aware of the SONIA index which will be published by the Bank of England and could be used as a future reference for a product based on SONIA compounded in arrears.
- **Independent advice** – It may be appropriate for the bank to suggest that the client considers advice from independent professional advisers on their options, if they have not already done so in relation to the LIBOR transition more generally.
- **Lending margin (or margin for other products, e.g. derivatives)** – In order to maintain similar commercial terms for the relevant product (whether it be a loan, derivative or other product), the margin may be adjusted by the bank to reflect the difference between LIBOR and SONIA. In particular, the bank may consider:
  - Explaining that in order to maintain the commercials of the loan, the lending margin needs to be adjusted and that such adjustment is not to increase the overall level of interest charged by the bank. This is consistent with Bank of England and FCA communications, in the context of firms with existing LIBOR-referencing arrangements, that a "fair conversion will involve the addition of a small adjustment to account for this difference".[35]
  - Providing the methodology and independent data source used to calculate the difference between LIBOR and SONIA.
  - Explaining to the client that future levels of SONIA and LIBOR are uncertain and there is a risk that the SONIA loan will have higher interest payments than a LIBOR loan in the future.

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Bank perspective
continued

Record keeping

The bank considers the records it needs to retain in order to demonstrate decision making based on information available at a particular point in the transition. This may include records of material communications with the client, as well as rationale for the product options provided to the client.

End user/client perspective

Risk identification – understanding of product options and operational readiness

The client or end-user seeks to understand the alternative products offered, including relative benefits, risks and operational implications. The client or end-user also assesses its own readiness to process the alternative products, including a loan based on SONIA compounded in arrears.

Independent advice

The client or end-user seeks to understand the alternative products offered, including relative benefits, risks and operational implications. The client or end-user also assesses its own readiness to process the alternative products, including a loan based on SONIA compounded in arrears.

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A

Case Study A
Bilateral/ syndicated loans

Bilateral or syndicated corporate borrowing through a SONIA-based, or Bank of England base rate, loan

Description

a) Bilateral loan – A mid-sized corporate borrower is seeking five-year finance to facilitate the expansion of its business in the UK. The corporate borrower approaches Bank A to discuss the terms on which it can borrow. In light of the likely discontinuation of LIBOR at the end of 2021, Bank A offers loan products to the corporate borrower that reference alternative rates, fixed rate loan options and LIBOR (with robust fall back language and/or clear contractual arrangements to facilitate conversion ahead of the end of 2021). The corporate borrower enters into a SONIA-based loan with a notional of £10 million, maturity of five years, with quarterly interest payments referencing SONIA compounded in arrears with a five-day lookback period (lag approach).

Bank A prices the loan at SONIA + 200 basis points (bp), compared to indicative pricing for a comparable LIBOR loan of 3m GBP LIBOR + 185bp, reflecting an average spread between LIBOR and SONIA of 15bp.

b) Syndicated loan – The customer is a large corporate wishing to borrow £100 million. Due to the size of the borrowing, the loan is syndicated with Bank A acting as lead arranger and Banks B and C also participating in the syndicate. The duration and pricing of the loan are consistent with the bilateral loan above.

c) Small corporate borrower – A small corporate borrower approaches Bank A wishing to enter into a new GBP loan. Bank A offers loan products that reference alternative rates as well as the option of a fixed rate loan. The small corporate borrower enters into a Bank of England base rate loan with a notional of £0.5 million. The duration and pricing of the loan are consistent with the bilateral loan above.

Rationale for approach adopted

Bilateral loan (a) and syndicated loan (b)
Bank A offered the SONIA loan as an alternative to a GBP LIBOR loan which would mature after the likely discontinuation of LIBOR. Furthermore, the use of SONIA compounded in arrears is consistent with the RFR Working Group's note that "the UK authorities have made clear their preference for the market to adopt a broad-based transition to SONIA compounded in arrears for new transactions, with the use of a TSRR being more limited than the current use of LIBOR "[36], where TSSR refers to the Term SONIA Reference Rate.

Forward-looking term SONIA rates were not available at the point of the customer request. Where available (and subject to relevant industry and regulatory expectations, which are still developing, particularly for the loans market) Bank A could consider offering a forward-looking term SONIA rate loan as one possible alternative.

SONIA compounded in arrears facilitates hedging of the loan as this is broadly aligned with conventions in the SONIA swap market, should the client so wish.

As a general point, it should be noted that different loan conventions may emerge in different markets and it is likely that market participants will use conventions as relevant to the market in which they operate.

Small corporate borrower (c)
The small corporate borrower entered into a Bank of England base rate loan due to having a greater understanding as to how the rate is calculated compared to SONIA, and there being no need to align with the swaps market (as the customer is not hedging the loan).

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A

Case Study A
Bilateral/
syndicated loans
continued

Risks to market effectiveness or market fairness

Subsequent developments could lead the customer to conclude that they would have been better served by Bank A adopting an alternative approach.

For example:

- the spread of LIBOR over SONIA could narrow over H2 2020 such that interest payments would have been lower with the LIBOR loan. The client might conclude it would have been preferable to extend the LIBOR loan until the end of 2020; or
- forward-looking term rates become available for use in Q3 2020 and would have been better for the corporate in terms of cashflow forecasting and liquidity management; or
- given that conventions in the loan market are developing, the standard could, for example, become a different lookback window or the adoption of the Bank of England SONIA Compounded Index. The corporate would then need to make additional changes to its treasury systems to be able to process future loans.

Additionally, for the syndicated loan the costs of borrowing for the corporate borrower could be greater if only a limited number of banks are able to participate in the syndicate due to operational constraints preventing some banks from entering into SONIA-based loans. However, the likelihood of this eventuality arising should diminish over time in light of the RFR Working Group recommendation that by the end of Q3 2020 lenders should be in a position to offer non-LIBOR linked products to their customers.[37]

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A

Case Study A
Bilateral/ syndicated loans
continued

Good practice observations

The good practice observations highlighted on pages 12 and 13 are relevant for this case study. In particular:

Bank

Communicating with clients – product options and pros/cons

- Bank A makes the mid-sized corporate aware that a forward-looking term SONIA rate may be available in the future but is not yet available.
- Bank A also makes the mid-sized corporate aware that product conventions (for example the five-day lookback period for the SONIA compounded in arrears loan) may change in the future, as the market is still developing. Bank A may also provide examples of conventions from public loans that have recently been originated.

Treating customers fairly - lending margin

- Given that Bank A uses the spread between LIBOR and SONIA to justify a change in margin from 185bp to 200bp, Bank A provides the methodology and independent data source used to calculate the 15bp spread adjustment.

Treating customers fairly and communicating with clients – small corporate borrower

- Where there are heightened information asymmetries between Bank A and its customer, consideration may need to be given to additional communication steps that Bank A should take to explain the options available to the client and, in this instance, the choice of Bank of England rate as the alternative rate as opposed to SONIA.

Corporate

Understanding of product options and operational readiness

- The corporate assesses whether to wait for a potential forward-looking term rate but may consider that given the macroeconomic uncertainty it is better to refinance now using SONIA rather than risk having to renegotiate a LIBOR loan in the future.
- The corporate may determine that it is able to book the SONIA-based loan using a tactical solution while it upgrades its treasury system.

Independent advice

- The corporate may decide to take advice from an independent professional adviser on the implications of a SONIA loan.

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B

Case Study B
Loan with interest rate swap

Corporate borrowing through a SONIA-based loan and simultaneously entering into an interest rate swap to fix the interest payments

Description

A corporate is seeking finance to invest in a new manufacturing facility and wishes to enter into an interest rate swap to fix interest payments. The corporate borrower enters into a SONIA-based loan with Bank B with a notional of £10 million, maturity of five years, with quarterly interest payments referencing SONIA compounded in arrears with a five-day lookback period (lag approach). Simultaneously, Bank B and the corporate enter into a SONIA-based interest rate swap with notional of £10 million, maturity of five years but with interest period ending on the interest reset date with no five-day lookback.

Rationale for approach adopted

- Bank B offered the SONIA loan as an alternative to a GBP LIBOR loan which would mature after the likely discontinuation of LIBOR. This is consistent with FCA guidance that the "most effective way to avoid LIBOR-related exposure is not to write new LIBOR-referencing business".
- The corporate wanted to swap to fixed interest payments and so selected a loan using SONIA compounded in arrears to align as closely as possible with the swap.
- As of H1 2020, five-day lookback periods with a lag approach have been used in the majority of loans and bonds.

Risks to market effectiveness or market fairness

- There is a disconnect between the five-day lookback period on the loan and the interest period in the swap which could drive basis risk.
- Loan conventions may in the future evolve to a two-day lookback. The corporate may feel that they should not have used a five-day lookback.
- Alternatively, loan conventions could evolve to a backward-shift approach which could enable basis risk to be avoided if the interest periods of the loan and swap are aligned – although this potentially triggers other issues.
- Additionally, the risks applicable to loans on a standalone basis as set out in Case Study A, such as the spread of LIBOR over SONIA narrowing over the course of 2020 such that interest payments would have been lower with the LIBOR loan, or the future availability of forward-looking term rates, are equally applicable in this context.

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B

Case Study B
Loan with interest rate swap
continued

Good practice observations

The good practice observations highlighted on pages 12 and 13 are relevant for this case study. In particular:

Bank

Communicating with clients – product options and pros/cons

- Given that the corporate wants fixed interest payments, Bank B includes a fixed rate loan as one of the product options, along with floating rate loans with a swap.
- It may be appropriate for Bank B to make the corporate aware that product conventions (for example the five-day lookback period using a lag approach for the SONIA compounded in arrears loan) may change in the future, as the market is still developing. Bank B may provide examples of conventions from public loans that have recently been originated.
- Bank B may offer alternative swaps to hedge the SONIA loans and explain the impact, cost and basis risk, for example:
  - A standard swap with the interest period ending on the loan interest reset date, which is five days different to the lagged interest period for the loan and therefore drives basis risk.
  - A standard swap with the interest period ending five days earlier to align with the lagged interest period of the loan to reduce basis risk, although this creates other potential issues with different cashflow dates and accounting treatment if there is a month end during the five-day lag.
  - A bespoke swap which perfectly matches the loan, but which has a higher cost.

Bank

Additional considerations

- Bank B may need to wall-cross its interest rate derivative salesperson to enable access to the specific information related to the loan to be hedged, so that the salesperson can provide alternative options for the swap. Appropriate conflict of interest protections should be considered.

Corporate

Understanding of product options and operational readiness

- The corporate considered a fixed rate loan but selected a SONIA loan with a swap to give more flexibility.
- The corporate weighed up the pros and cons of the different product options, including transaction costs and hedging accuracy, and selected the standard swap with the small basis risk.

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C

Case Study C
Cross-currency swaps

Coroprate entering into a USD LIBOR-SONIA swap to hedge exposure arising from GBP loan and USD investment

Description

Following on from Case Study B, the manufacturing facility in which the corporate borrower invests is based in the US. However, the UK-based corporate wishes to borrow in GBP. In light of the discontinuation of LIBOR, Bank C offers the corporate borrower loan products that reference alternative rates and the corporate selects a loan referencing SONIA. In order to hedge the cross-currency exposure arising from the GBP loan and USD investment, Bank C also offers the customer different cross-currency swap options, including USD LIBOR-SONIA and SOFR-SONIA swaps. Due to liquidity in the GBP and USD RFR markets, the customer enters into a USD LIBOR-SONIA swap (the receive leg of the swap hedging the loan exposure therefore references SONIA but the pay leg references USD LIBOR), so that the corporate is effectively paying an interest rate referencing USD LIBOR.

Rationale for approach adopted

- At the point of the transaction, SONIA loans have become market standard with attractive pricing for the corporate. By entering into a SONIA loan, rather than a LIBOR loan, the corporate also avoids the need to amend the loan in the future before LIBOR is discontinued. There is also sufficient liquidity in SONIA swaps that the corporate could alter position at a reasonable cost if circumstances change (e.g. once part of the borrowing is paid back).
- Liquidity in RFR markets may develop at different paces. In particular, the USD LIBOR-SONIA cross-currency swap market may be more liquid than SOFR-SONIA cross-currency swaps. Lack of liquidity in the USD SOFR market means that spreads would be much wider and the swap rate and subsequent alterations could be costly.
- The corporate has updated its systems to allow booking of SONIA products, but is not yet able to book SOFR products.

Risks to market effectiveness or market fairness

- Given that the USD leg of the swap references LIBOR, this leg is likely to need to be amended at a later point once liquidity has developed further in the USD SOFR market and so could increase transaction costs and/or operational burden for the corporate borrower. However, such an approach may also result in better customer outcomes depending on when liquidity shifts in each of the currencies. The transaction costs and/or operational burden may be mitigated where both parties to the contract are adherents to the ISDA protocol on the basis that the contractual fall back provisions would automatically provide for adjusted versions of the RFRs as replacement rates upon the relevant trigger event.
- The risks highlighted in Case Study A in respect of the refinancing of the loan are equally applicable here.

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Case Study C
Cross-currency swaps
continued

Good practice observations

The good practice observations highlighted on pages 12 and 13 are relevant for this case study. In particular:

Bank

Communicating with clients

- Bank C alerts the corporate borrower to relevant additional considerations for cross-currency swaps. These considerations could include liquidity in the GBP and USD RFR markets.

Monitoring

- Bank C continues to monitor the evolution of liquidity in the SOFR market and considers the appropriateness of providing periodic updates to the corporate borrower. This monitoring could be used to inform if and when the USD LIBOR leg can be transitioned.

Additional considerations

- Bank C assesses the application of accounting and regulatory reliefs as well as hedging treatment where a transaction is subsequently amended.

Corporate

- An assessment of the application of accounting and regulatory reliefs may also be a relevant consideration for the corporate borrower.

Understanding of product liquidity

- The corporate may assess relative liquidity in SONIA and SOFR swaps and decide to delay amending the USD leg due to the lower maturity of SOFR derivatives.

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Topic 2: Buy-side focused risks – switching performance benchmarks

Fund managers may use LIBOR, or reference indices based on LIBOR, as benchmark or performance targets for their funds or mandates. This is particularly the case for fixed income funds and alternative strategies. Such benchmarks or performance targets will therefore need to be transitioned ahead of LIBOR discontinuation.

For certain funds, there may be a correlation between the underlying assets of a fund and the performance benchmark. Therefore, where such performance benchmarks are to be transitioned this will also likely necessitate changes to the underlying investments in order to correlate with the new benchmark.

D

Case Study D
Switching performance benchmarks

Fund manager switches performance benchmark of fund to SONIA

Description

A fund manager has a number of fixed income funds and alternative strategies with different characteristics that use LIBOR-linked benchmarks or performance targets. Given the imminent discontinuation of LIBOR at the end of 2021, the fund manager proposes that during Q1 2021 it will change each of Funds A, B and C from the GBP LIBOR benchmark rate to a SONIA-based rate. In each case, the benchmark is updated in March 2021 from GBP 3M LIBOR + 185bp to SONIA + 200bp, reflecting an average spread at that point in time of 15bp between LIBOR and SONIA.

Fund A – in accordance with its investment guidelines, Fund A seeks to generate an investment return that is near to a benchmark dependent upon GBP LIBOR. Therefore, there is a correlation between the benchmark and underlying fund assets which will be impacted when transitioning the benchmark from GBP LIBOR. There is no performance fee.

Fund B – uses a GBP LIBOR-linked index as a reference against which the fund performance is benchmarked. It is therefore the underlying strategy that drives the investment. The investment guidelines do not stipulate that the underlying assets of the fund need to correlate to the benchmark. There is no performance fee.

Fund C – has the same investment guidelines as Fund B but charges a performance fee.

Rationale for approach adopted

- The fund manager wishes to switch the benchmark of a fund to SONIA instead of GBP LIBOR to prevent any unnecessary uncertainty in fund performance under a LIBOR cessation event or LIBOR being declared unrepresentative. This is consistent with the FCA's comment that asset managers and fund managers will need to "assess and manage risks associated with LIBOR ending".[38] This action must be taken before the end of 2021.
- The fund manager does not want to wait until the end of 2021 as this could have adverse financial impacts on investors. This risk is most relevant for Fund A where underlying fund assets will be impacted when transitioning the benchmark from GBP LIBOR.
- In the event that investors suffer losses, they may assert that those losses were caused or exacerbated by the late switching of the relevant fund's benchmark and that this could be regarded by regulators and/or ombudsmen as poor management, as opposed to market risk, and therefore that investors should be compensated. This is particularly notable given the fiduciary duties that fund managers owe their investors.

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D

Case Study D
Switching performance benchmarks
continued

Risks to market effectiveness or market fairness

Subsequent developments could lead investors to conclude that they would have been better served by the fund manager adopting an alternative approach. For example:

- Should the spread of LIBOR over SONIA narrow during H2 2021, it might impact resultant analysis of fund performance and have implications on underlying portfolio investments.
- The fund manager faces the additional burden of determining what the new benchmark should be and the potential adjustment spread that needs to be added. For Fund C, given the existence of a performance fee, in case of any errors in determining the new benchmark and adjustment spread, the fees charged to investors may be impacted.
- Investors may perceive that the timing of the transition of the performance benchmark unfairly advantaged the fund manager, e.g. by transitioning at a point in time that could misrepresent fund performance.
- For Fund A, given the correlation between the benchmark selected and the underlying fund constituents, the timing of the benchmark change and, where necessary, the transitioning of the underlying constituents may be particularly sensitive. Furthermore, given the transition of some of the assets in Fund A from LIBOR to SONIA may be subject to external dependencies, this could present challenges when determining the timing of the shift to the SONIA-based benchmark.

Good practice observations

The fund manager may consider the following issues:

Communicating with clients

- Alerts – Alerting investors and distributors to potential risks of new RFR products particularly in markets where consensus is still developing and taking into account different client needs. The nature and sophistication of investors may determine the approach and type of communication required. The fund manager may also consider evidencing and measuring the effectiveness of these communications.
- Documentation updates – Updating the prospectus, investment strategy or objectives of the relevant fund and all other associated documentation before transitioning to the updated benchmark.

Treating customers fairly

- Investor approvals – Considering whether investor approval is required in light of the governance requirements of the relevant fund. In certain instances, the change in benchmark could be regarded as a ‘significant’ change event, in which case the fund manager may need to inform investors a reasonable time before the switch to an alternative benchmark and/or hold an investor vote before proceeding.

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D

Case Study D
Switching performance benchmarks
continued

- Choice of replacement reference rate - In this case study the fund manager chooses SONIA + 200bp as the replacement reference rate for each of Funds A, B and C. This takes into account the FCA's view that "firms are more likely to be able to demonstrate 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".[39] The fund manager may also provide examples of the general conventions and/or specific transaction conventions from relevant benchmarks and highlight the aspects of the conventions that may change in the future.

Governance

- Senior managers – Making senior managers aware of the risks arising from transitioning fund benchmarks and, where appropriate, considering who is accountable for managing this aspect of the transition.
- Benchmark options – Reviewing decision-making processes and governance structures for analysing different benchmark options and identifying the relevant benchmark to switch to for each fund and the applicable spread.
- Performance fees and return – For Fund C where there is a performance fee, it may be appropriate for the fund manager to consider the impact of the change in benchmark on performance fees and returns to investors for governance and decision making, and where relevant, client disclosures.
- Product governance – Assessing whether changing the benchmark modifies the product's characteristics and whether it continues to meet the objectives and remains fit to be marketed to its target market. This is likely to be particularly relevant for Fund A where the underlying constituents will be transitioned to track the new benchmark.
- Investment updates – For Fund A, where the change of benchmark requires changes to underlying constituents to track the benchmark as per the investment guidelines, the fund manager may need to consider the impact of such a change in decision making. Fund A may incur costs on transitioning LIBOR-based holdings to other assets. It could therefore be appropriate for the fund manager to consider the potential costs, how they may vary based on the timing of the transition, and whether the cost is charged to Fund A, or if any part is borne by the fund manager.
- Investor approvals – Considering whether investor approvals are required in light of the governance requirements of the relevant fund. In certain instances, the change in benchmark could be regarded as a 'significant' change event, in which case the fund manager would need to hold an investor vote before proceeding.
- Record keeping – Retaining appropriate records to demonstrate decision making based on information available at a particular point in the transition. This may be particularly relevant where decisions impact investors.

Conflicts of interest

- Record-keeping – Considering and documenting conflicts of interest and different client needs when deciding the alternative rate, spread and timing of the change in benchmark.

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Case Study D
Switching performance benchmarks
continued

Where acting as distributor, considerations include:

Conflicts of interest

- Incentives – Ensuring sales targets or incentives are not related to switching benchmarks, particularly in relation to less sophisticated investors, and implementing any necessary updates to related internal controls and reporting. Considering steps to mitigate any conflicts caused by the impact, positive or negative, that switching benchmarks might have on sales targets.

Contents

ARRC	Alternative Reference Rates Committee
Backward shift approach	A method for adjusting the period over which an RFR is observed by backward shifting both the rate and the weighting of that rate by a number of banking days.
bp	Basis points
Fall back	Arrangement that will apply upon a trigger event, for example on the permanent discontinuance of LIBOR.
FCA	Financial Conduct Authority
FMSB	FICC Markets Standards Board
Forward-looking term rates	A term rate which reflects the expected average SONIA (or other RFR) over a given period.
FSB	Financial Stability Board
GBP	Great Britain Pound
Lag approach	A mechanism whereby the interest observation period lags the RFR reference period by a fixed number of banking days.
LIBOR	London Inter-Bank Offered Rate
Lookback period	Number of banking days by which an observation period is lagged. In a lookback approach, on each day of the interest period the rate from [X] banking days prior is used.
RFR	Risk-free rate
SOFR	Secured Overnight Financing Rate
SONIA	Sterling Overnight Index Average
TSRR	Term SONIA Reference Rate
USD	United States Dollar

Contents

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