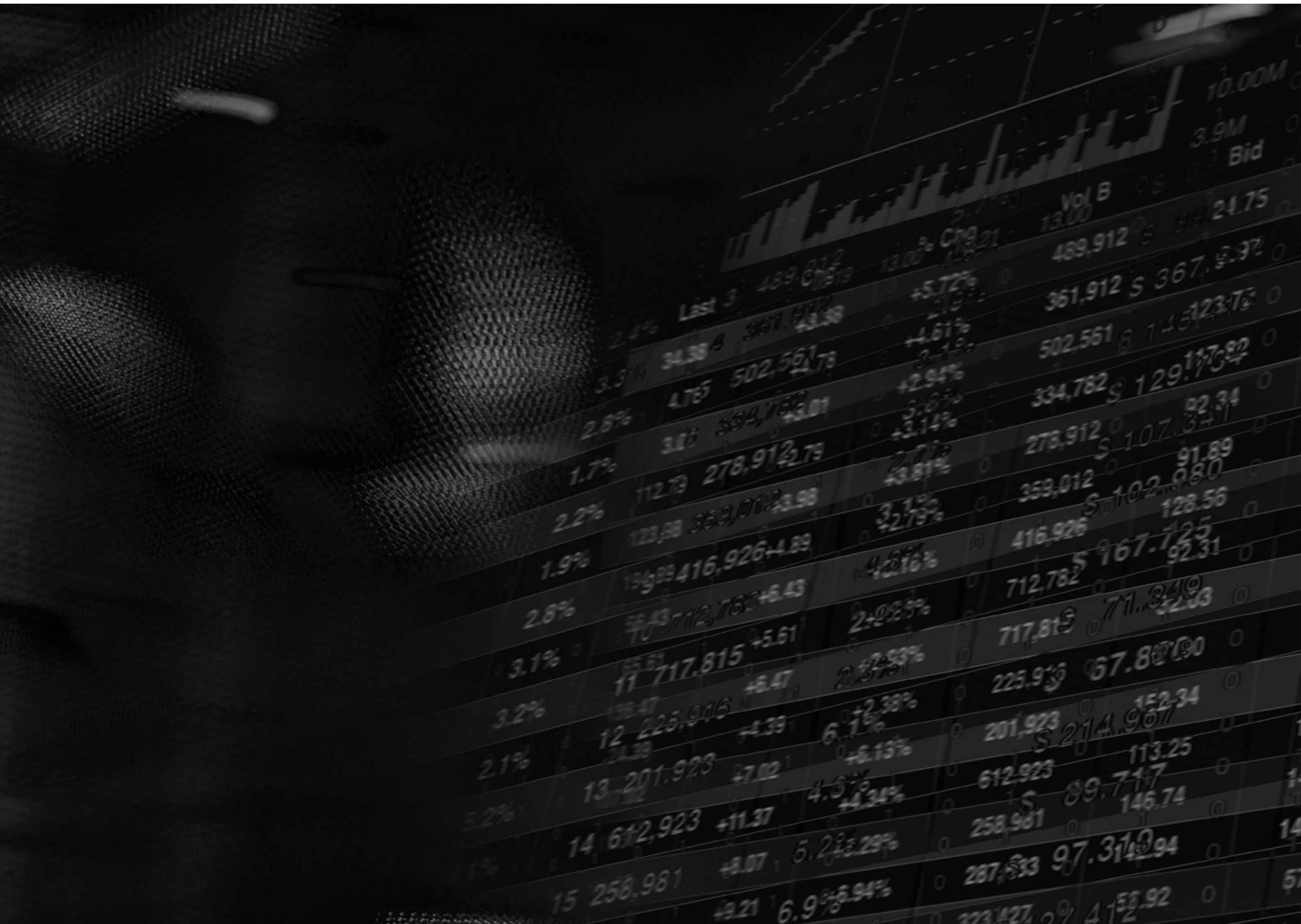
CONDUCT RISK AND THE IMPORTANCE OF CLIENT COMMUNICATION IN THE LIBOR TRANSITION

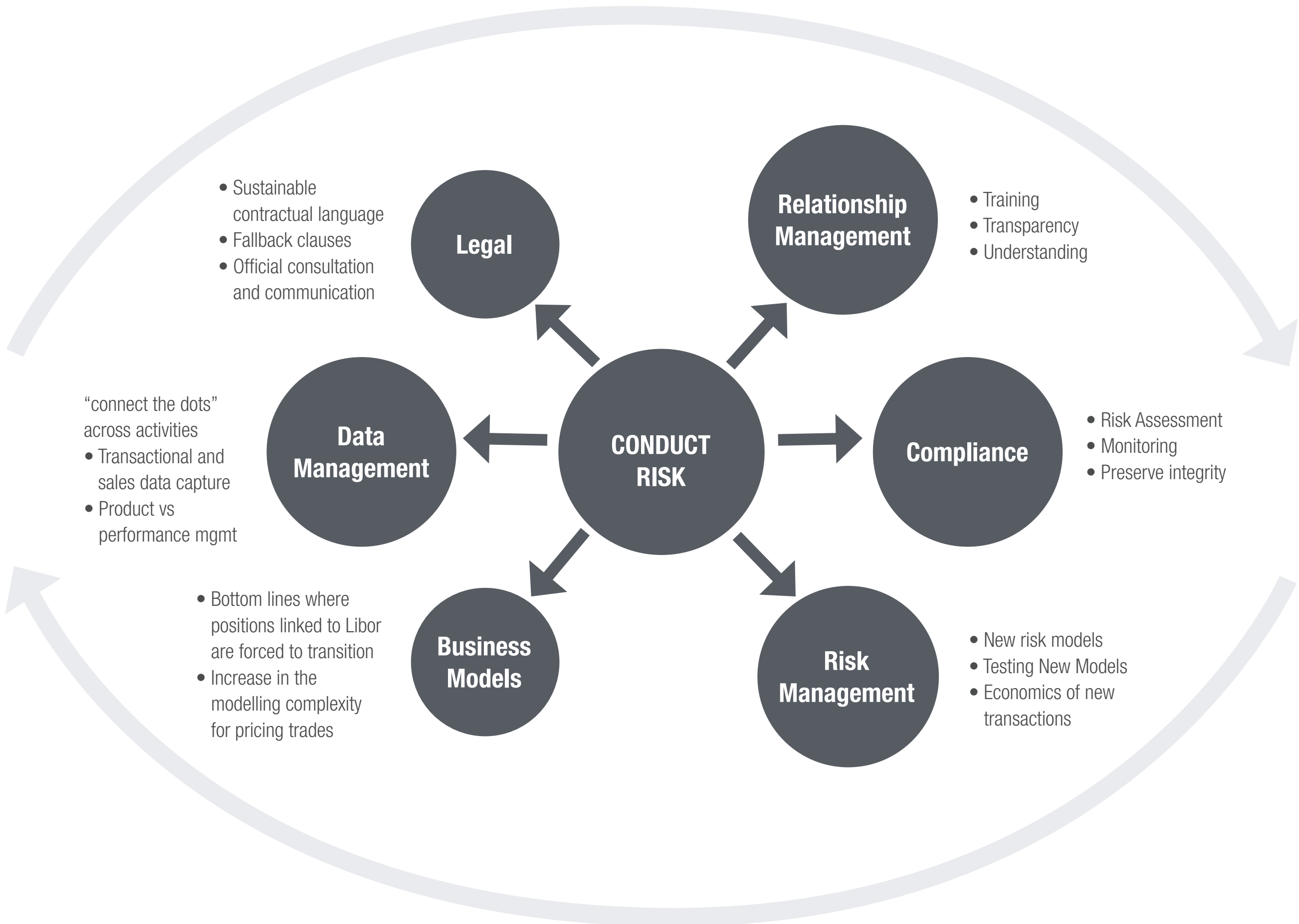


INTRO

As the industry accelerates its preparations for a move away from the long-standing LIBOR benchmark to new risk-free reference rates (RFRs), all of the many participants impacted by the transition need to take a hard look at the robustness, and hence suitability, of their conduct risk framework.

Buy-side and sell-side institutions with investors in LIBOR products have clear fiduciary duties towards those clients, and since its establishment in 2013 the UK Financial Conduct Authority (FCA) has adopted a far more wide-ranging approach to managing customer-related risks. In particular, Treating Customers Fairly (TCF) has placed the onus on to firms "… to show consistently that treating customers fairly is at the heart of their business model"[1].

This emphasis placed on treating customers fairly has required institutions to implement a company-wide framework that focuses on managing and mitigating conduct risks as they arise. Conduct risks arise at different stages across the customer journey, and the overall impact of these conduct risks fall into three broad areas: the nature of the relationship with the client; the types of products and services offered; and the customer profile.



1. https://www.fca.org.uk/firms/fair-treatment-customers

As the transition from LIBOR gathers pace, industry players must consider how new RFR products, new organizational structures, and copious complex legal restructurings will shape the future state of their organization. Although uncertainty persists around whether LIBOR will truly be phased out by 2022, the clock is certainly ticking - and at the heart of this transition challenge is the customer.

It is no easy feat to communicate to your clients how these new products and market changes will really impact them. Understanding emerging customer needs, and translating those needs into a set of tangible requirements and tasks (both externally and internally), requires a delicate balancing act – one that will test the robustness and strength of established Conduct Risk Frameworks at every stage of the transition.

When gauging how to approach this challenge, the three examples below illustrate scenarios wherein the conducts risks vary considerably. Across all three, the features, payment profiles and risk profiles of the transactions will be subject to change as the old benchmark comes to an end:

1) Managing changes to existing or legacy contracts with LIBOR links;

2) Continuing to offer LIBOR-linked products during the transition;

3) Releasing new products that are linked to any of the new risk-free rates.

Setting the foundations of an enterprise-wide approach for delivering great customer outcomes while also maintaining market integrity is the best mechanism to ensure that customers are treated fairly.

The challenges associated with managing this conduct risk are complex, as it is difficult at any point to assess (with real certainty) which party to a transaction will emerge better or worse off post-transition. This is down to the methodology by which transactions will be priced, which will differ from a LIBOR-based product and could involve complex cross-currency challenges. As things currently stand, the precise timing of the transition is yet to be locked down; the fall-back rates and contractual change processes have not been agreed; and there remain some critical accounting, tax and regulatory safe harbours still to be confirmed by the relevant authorities before the transition can occur.

This transition is not a ‘swap in, swap out’ affair, whereby you simply substitute an RFR for LIBOR in those products or contracts that reference the established benchmark. Expected cash flow challenges will likely be altered radically, and the way they behave as interest rates change will pose serious liquidity challenges for most institutions.

If, hypothetically, this challenge could be met without causing mass disruption (via a simple swap-in/swap-out benchmark), there would still be a larger industry problem – namely, what roles do fallback language and provisions play should LIBOR disappear completely? As these provisions were designed to cover the temporary unavailability of LIBOR rather than a permanent exclusion, the fundamental market economics that underpin product offerings will change. For example, if an institution decides to convert a floating-rate product into a fixed-rate product, the holder (counterparty) of a LIBOR contract would suffer economic loss, whereas the other counterparty would receive significant gains.

In order to manage risks and ensure that the best possible customer outcomes are delivered and market integrity is protected, the established governance structure must highlight the importance of achieving virtuous customer outcomes. To this end, it should implement a risk management infrastructure capable of mitigating key risks arising from business operations within the parameters of a specific risk appetite. In addition, the infrastructure itself must be robust and resilient.

Due to the sheer number of complex market scenarios that will test a conduct risk policy, it is critical that the transition framework policy can accommodate change – demonstrating a capacity and capability to evolve both in parallel with market standards and as the requirements around the new benchmark become more stringent.

Building a communication strategy that allows institutions to share information and track their engagement with customers is one methodology advocated by Capco to manage this transition. There are several considerations here. How can changes to portfolios/positions/products be communicated without the appearance of advice being given? What are the firm-wide policy considerations in those instances where customers require a change in products? What should be communicated, by what mechanism and in what detail? How do you ensure that you treat customers fairly, for instance avoiding any suggestion of favouritism?

Running through all those considerations is the need to communicate at the right level. If the LIBOR transition is not to degenerate into a re-run of the UK's Payment Protection Insurance (PPI) scandal, customers must be made fully aware of what the changes mean to them. Unfortunately, not all customers will possess the same base understanding – and so education will need to be 'tiered' and tailored to accommodate different needs. Factors such as geographical location (and hence mother tongue) and the nature of the language used (clear and not overly technical) are two further immediate concerns an institution will need to address.

Although the industry will look to simplify and universalise contracts and fall-back language as best they can, some customers will as noted require further education and hence a more detailed level of communication. Currently, it is a challenge to comprehensively determine a satisfactory communication strategy, as it is not yet entirely clear what should be communicated and to whom any changes should be communicated.

Leading industry bodies are offering guidance related to impacted product classes, and firms should consider integrating that advice into their Conduct Risk Framework. For derivatives, the International Swaps and Derivatives Association (ISDA) is set to issue transition guidance alongside the Loans Market Association (LMA) and the International Capital Market Association (ICMA) as regards debt and cash products respectively.

Within any transition conduct risk assessment it will be key as a first step to identify potentially affected customers and products. Classification of customers into groups will assist in developing an appropriate approach for different cohorts within impacted customer segments. Higher-risk or challenging customer groups will include vulnerable customers, trusts and small corporates. Complex transactions will include mortgages, syndicated loans, derivatives that potentially become imperfect hedges, and those transactions where floating payments potentially become fixed.

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