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FINANCIAL SERVICES FACULTY

10 QUESTIONS YOUR FIRM SHOULD BE ASKING ABOUT CONDUCT RISK IN THE CONTEXT OF LIBOR TRANSITION

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The London Inter-Bank Offered Rate (LIBOR) has been the most widely used interest rate benchmark in financial markets and the daily published rates are referenced in an estimated total of around US$400 trillion of financial contracts, including loans, mortgages, bonds, securitised products and derivatives. The transition from LIBOR to the alternative reference rates (RFRs) is essential to strengthen the global financial system and with the end-2021 LIBOR cessation date firmly held, a significant effort is required to effect this change. Given the potential for misconduct when transitioning away from LIBOR, conduct risks need to be carefully considered and assessed. ICAEW's Financial Services Faculty highlights 10 questions you can ask to build a robust conversation around how your firm is addressing conduct risk arising from LIBOR Transition.

1. Has my firm identified those conduct risks that could present themselves with LIBOR Transition?

Given the potential for misconduct when transitioning away from LIBOR, it is essential that your firm undertakes a process for the identification of LIBOR Transition conduct risks. This may highlight existing conduct risks that are either generic or heightened due to the transition, or identify new risks such as the timing of contract repapering and potential for value transfer.

- ❑ Does your firm maintain a taxonomy for conduct risk that is relevant to your business and does the transition present new or enhanced conduct risks?
- ❑ Ensure your firm has gone through an exercise of identifying relevant conduct risks for LIBOR Transition, which may cover key themes including governance, information asymmetry, conflicts of interest, communication, product development, firm misconduct and market integrity.
- ❑ Have we identified businesses and products which are more susceptible to conduct risks due to their nature of the financial product and the sophistication of customers?

2. Has my firm gone through the process of assessing the suitability of your conduct risk control framework?

The existing control framework needs to be carefully assessed in light of the transition related conduct risks identified to help develop a framework fit for purpose to mitigate such risk.

- ❑ Ensure your firm has undertaken a gap analysis against its existing conduct risk control framework (if applicable).
- ❑ Do you have the necessary controls to mitigate the conduct risks?

- ❑ Have you Identified how the existing conduct risk framework can be applied to the transition program, in particular the transition of the legacy LIBOR portfolio?

3. If our program is considering conduct risk, has my firm defined some specific measures to assess and monitor the effectiveness of the program with respect to conduct?

Consideration needs to be given to how your firm monitors and documents the mitigation of conduct risk as part of its program, including what type of ongoing monitoring and management information is needed to ensure the effectiveness of controls.

- ❑ Are the controls embedded into your standard control assessment operating model?
- ❑ Has your firm implemented controls to mitigate conduct risk through an offline process and if so how is this being monitored for effectiveness?
- ❑ Can we generate relevant metrics in order monitor conduct risk during the transition process itself?
- ❑ Are these metrics being provided to a senior enough level to ensure the progress of the transition can be challenged and do I need to look at these metrics?
- ❑ Are we capturing customer feedback on the transition in structured manner, so we can adapt the program and respond to customer needs?

4. What are some examples of how conduct risk can manifest itself in my firm’s transition program?

Due to the level of complexity and uncertainty in transitioning from LIBOR to the alternate RFRs, conduct risks can arise from (but not limited to):

- Customers not receiving appropriate communications on LIBOR transition or do not receive the information in a timely or accurate manner.
- Selling or transacting in unsuitable products during LIBOR transition.
- Using asymmetric information to disadvantage others during the transition.
- Inserting fallback provisions in the contract that is neither robust nor fair e.g. because the replacement rate replacing LIBOR is not considered economically comparable to LIBOR.

- ❑ Has your firms conduct risk assessment considered these types of examples and how they would be handled?

5. What are some examples of the type of controls and processes that my firm should have in place to manage these conduct risks?

Controls which you would expect to have in place to mitigate LIBOR transition conduct risk should encompass (but not be limited to):

- Robust governance of the program to provide strategic direction and oversee the key aspects of the program including product development, contract management and client communications, with record keeping documenting decision-making.
- Internal training (including training on conduct risk) to ensure that client facing staff are fully aware of the development and impacts of LIBOR transition.
- A documented and considered communication strategy to educate clients and support them through transition.
- Product approval process to oversee the development of new RFR products which also incorporates conduct risk considerations.

- ❑ Does your firm’s conduct risk control framework include these controls and others?

6. Has my firm trained internal teams on potential conduct risk in the transition?

The LIBOR transition program will be a large and complex exercise for many firms. The purpose and the outcome of ensuring fair outcomes for clients will be a critical part of an effective transition program. To support this it is important that employees supporting the transition program are clear on their firms overall conduct objectives through clear communications and training.

- ❑ Are there clear communications on a firm’s LIBOR conduct?
- ❑ Are their accessible materials and guidance internally for staff?

7. How aware are our customers of the transition, the impact on their business and their own level of readiness?

Firms must communicate information to customers in a way that is clear, fair and not misleading. Customers should be kept appropriately informed about the impact of LIBOR cessation on both existing and new financial products and services they offer or distribute. Information should be timely to allow customers to make informed decisions about relevant products and the risks to which they may be exposed.

- ❑ Has your firm developed a communication strategy which is tailored to your client base?
- ❑ How is you firm ensuring the consistency of message and monitoring its communication with clients?
- ❑ Have we trained our own staff to ensure they can inform customers in a consistent manner of potential impact transition and the actions they may need to take?

8. Is there a structured customer outreach program in place for the back-book transition to ensure consistent outcomes?

The back book of existing LIBOR transactions will need to be proactively transitioned in advance of the end of 2021 (with only ‘Tough Legacy’ positions outstanding at this date). To ensure positive customer outcomes from this the conduct risk will need to be considered as part of the outreach program. Considerations should include:

- A clear path or options for transitioning clients from LIBOR to replacement rates.
- Clients can see the potential future risks or economic differences of selecting a new benchmark.
- Demonstration that the transition options are industry standard.
- Any economic adjustments as a result of the benchmark changing are done in a transparent manner applying standard industry approaches.
- The information provided to customers is recorded and evidence of communications and client decisions agreed are logged.

9. Has my firm demonstrated that we have taken reasonable steps to manage the conduct risk?

Given the volume of LIBOR transactions, the timeframe of the transition it will be challenging to demonstrate the positive steps taken to ensure positive customer outcomes and that firms have attempted to treat customers fairly. Examples for consideration include:

- Logging the communication education steps and activities taken internally.
- Have we communicated sufficiently with our customers and provided the right information?

❑ Ensure that your program has logged evidence of your communication in a structured manner in order to demonstrate that reasonable steps have been taken.

10. How is my firm considering the existing guidance available on conduct risk?

There have been some key publications both from the official sector and trade associations listed below:

- UK FCA has published a Q&A on conduct risk during LIBOR Transition, which highlights that existing regulation and guidance on conduct risk will apply in the UK – link available here
- FMSB has published two Spotlight papers on
  1. some of the potential LIBOR conduct scenarios including example case studies to navigate conduct risk – link available here
  2. looking at how market participants may manage potential conduct risks arising in back book transition – link available here
- AFME has published two papers on establishing an effective compliance framework - link available here; and conduct risk and client communications link available here

❑ These publications and case studies should be used to inform and challenge the LIBOR conduct framework. We recommend you are familiar with these publications.

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