The Working Group on Sterling Risk-Free Reference Rates

Andrew Bailey
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Financial Conduct Authority
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Regulatory barriers and enablers to LIBOR transition

Dear Mr Bailey,

I am the Chair of the Working Group on Sterling Risk Free Reference Rates (RFR WG), whose mandate is to catalyse a broad-based transition to using SONIA as the primary sterling interest rate benchmark in bond, loan and derivatives markets.

As part of executing that mandate, the RFR WG has identified a number of specific regulatory barriers likely to impede the adoption of SONIA in new transactions as well as the replacement of current exposures to Sterling LIBOR with corresponding exposures to SONIA and the adoption of robust contractual fallbacks. This letter sets out issues which we believe fall into the FCA's domain, alongside potential solutions which we would ask you to consider. The letter forms part of a wider dialogue with UK and EU regulatory authorities.[1]

'Tough' legacy contracts

Through its discussion of regulatory barriers, the RFR WG has identified a number of issues across sectors regarding 'tough' legacy contracts. These issues have been removed from the scope of this letter because they need to be considered more broadly in order to determine if and where a consensus exists, as called for in your speech of July 2019.[2] The RFR WG will report back as appropriate once it has considered this in further detail, noting that these issues are particularly acute for cash market products where any contractual amendments needed to address LIBOR discontinuation must be incorporated on a case by case basis.

EMIR and MIFIR requirements in relation to derivatives

(a) **EMIR margining and clearing obligations**

EMIR non-cleared derivatives margining and mandatory clearing rules do not apply to derivatives contracts which were already in existence as at specified points in time.[3] These 'legacy' derivatives may, however, come into scope of those rules in certain circumstances. Market participants are

[1] In particular, letters have been sent to EIOPA, the PRA, Basel and EU authorities outlining other issues the RFR WG has identified and for which regulatory assistance is required in order to facilitate adoption of SONIA. For completeness, the RFR WG has also sent a letter to the International Accounting Standards Board.

[2] https://www.fca.org.uk/news/speeches/the-future-of-libor

[3] 16th August 2012 for margining under Article 11(3) of EMIR. On or after the date on which the clearing obligation takes effect (or for transactions with certain remaining maturities, notification under Article 5(1) has been received) for clearing under Article 4(1)(b) of EMIR.

concerned that those margining and clearing obligations could be triggered by amendments to legacy derivative transactions which either:

(i) seek to enhance their contractual robustness by including fallbacks for benchmark-related events (such as the International Swaps and Derivatives Association's (ISDA) work on fallbacks for major interbank offered rates (IBORs) or the ISDA Benchmarks Supplement (which provides robust generic fallback provisions for use across interest rate, equity, commodity and fx benchmarks in response to Article 28(2) of the EU Benchmarks Regulation[4]); or

(ii) make amendments necessary to replace a benchmark which is perceived by regulators and RFR Working Groups as vulnerable to cessation (such as Sterling LIBOR) with references to a more robust benchmark (such as SONIA).

These benchmark reform efforts have been in response to efforts by the Financial Stability Board and other global regulatory and private sector concerns around systemic risks. They rely for their success upon their widespread adoption. Uncertainty as to whether such activities trigger margining and clearing obligations under EMIR will potentially pose a major impediment to those efforts.

While we are grateful for the steps that the FCA has already taken to provide comfort in relation to this issue[5], we ask that the FCA provide further confirmation that these activities would not on their own subject such contracts to the margining or clearing obligations.

We note, in this respect, that the BCBS/IOSCO published a statement on 5th March 2019.[6] We also note that the Chair of the EU Risk Free Rates Working Group recently wrote to the European Commission and ESMA on this issue[7]. We echo and support the terms of that letter which advocates for a broader approach consistent with the policy objectives of Article 28(2) and which would facilitate use of ISDA's Benchmarks Supplement. We therefore similarly request that any clarification from the FCA should extend to clearing obligations as well as margining obligations and should cover benchmarks generally rather than being restricted to interest rate benchmarks.

(b) **EMIR trade repositories (TR) reporting**

Given the importance of TR data to regulators, particularly for systemic risk monitoring, TR data will need to be updated as the industry transitions from IBORs to RFRs. We understand it is important for regulators to have access to TR data that accurately reflects market activity. We note that amendment of an existing derivative transaction so that it ceases to reference an IBOR, such as LIBOR, and instead references an RFR, such as SONIA, will see a large number of EMIR reports needing to be amended, possibly in a very short timeframe. Given the volumes of derivatives transactions already reported to TRs, there will be significant operational and technological work to update existing reports at the TRs. We would appreciate a discussion with regulators and

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[4] Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014.
[5] Minutes of the Sterling RFR WG 19th February 2018, p.3, sub-paragraph 10(iii)
[6] https://www.iosco.org/news/pdf/IOSCONEWS526.pdf
[7] Letter from Working Group on Euro Risk-free Rates to European authorities

infrastructure providers (such as trade repositories and middle-ware platforms) to look into this issue.

(c) **EMIR Risk Mitigation Techniques**

EMIR also contains provisions relating to risk mitigation techniques for non-cleared derivatives, such as timely confirmation, dispute resolution and portfolio reconciliation. The scale of amendments which will be needed for existing IBOR contracts will present significant challenges to firms' ability to meet these requirements for those existing contracts. We therefore request the FCA adopt a proportionate approach with respect to firms' compliance with those provisions for existing contracts until the logistical burden has been overcome.

(d) **MIFIR Trading Obligations**

MIFIR has mandated that certain interest rate derivatives referencing IBOR benchmarks have to be executed on platforms. While the mandatory trading obligation is related to the EMIR mandatory clearing obligation, we request that regulators consider the trading liquidity and other relevant factors before applying the MIFIR trading mandate to include risk free rate (RFR) referencing derivatives.

In particular, in the context of LIBOR transition where there are LIBOR-linked derivatives with fallbacks referencing SONIA, firms will have to report a change in their contracts from LIBOR to the new SONIA rate en masse, once that fallback provision is triggered. The fact that firms will have updated all transaction reporting to reference SONIA might in turn create an artificial impression that there is sufficient liquidity in SONIA swaps to meet the threshold for MIFIR trading obligations. The RFR WG welcomes clarity on the data source used to make the assessment of whether to submit an asset class to the trading obligation under MIFIR and assurance that activity related solely to LIBOR transition will not be counted towards the overall market liquidity to declare the trading obligation. This will inform whether further action is required by authorities to avoid any artificial counting of new SONIA liquidity which may result in an inappropriate determination being made. A premature mandate may have unintended and adverse consequences that create further risks to firms' ability to execute such derivatives.

(e) **G20 over-the-counter (OTC) derivatives reforms**

We request the FCA co-ordinates with the appropriate standard setting bodies to consider the other aspects of G20 derivatives regulatory reforms impacted by IBOR transition, including imposing new regulatory mandates (such as clearing and trading obligations) on new RFR instruments.

Permissions to enter into a regulated mortgage contract

There is a possibility that in order to successfully transition customers with an existing LIBOR-linked mortgage, a lender may need to enter into a new regulated mortgage contract in order to vary the contract. Not all lenders or book owners with LIBOR-linked mortgages will have the necessary FCA permissions to do so. This will need to be dealt with on a firm by firm basis, however from a legislative perspective a firm cannot 'enter into' a regulated mortgage contract if it does not have the permission to do so.[8] It may be that a firm could use a third-party administrator with the necessary permissions to carry out this activity on their behalf, however not all third-party

[8] Under the Financial Services and Markets Act 2000

administrators do. Supervisory guidance on appropriate ways to address such matters would be welcome.

Conduct Risk

The financial services industry recognises that a critical success factor to their transition programmes is ensuring they take appropriate actions to mitigate conduct risks and achieve fair outcomes for their clients. The effective management of conduct risks within LIBOR transition is complicated by the variety of products and jurisdictions involved and the diversity of customers and end-users that are impacted. Given the significant divergence in the sophistication of impacted customers across retail and wholesale sectors and given that there remain uncertainties about the development of alternatives and relevant conventions, firms are cautious about implementing solutions at this stage.

The RFR WG would welcome the development of industry best practice / guidelines to support firms in developing good conduct frameworks to support their transition. Below we highlight examples of conduct risks that firms are finding it difficult to navigate in developing their transition plans.

(a) **Selecting a replacement rate and treating customers fairly**

Through conversion of legacy products from LIBOR to SONIA there is the potential for a value transfer between parties. The RFR WG believes that all customers should expect to be treated fairly throughout the transition, and recognise there are market-led initiatives underway to help build consensus around conventions for replacing LIBOR. However, it should be noted that it will not be possible to guarantee that there will be no future value transfer between counterparties. The RFR WG seeks guidance on how firms should consider handling any potential value transfers at the point of transition and during any periods where LIBOR and SONIA continue in parallel, to ensure any replacement rate selected is considered fair. This would help encourage certainty and give comfort to parties within a transaction. The FCA's views are particularly important because some contract terms have clauses that replace LIBOR with a 'comparable' or 'equivalent' rate (as is the case within some LIBOR mortgages).

In addition, some contract terms replace LIBOR by referencing a rate / spread "designated, nominated, or recommended" by an authority / working group, as is the case within more recent loan and bond documentation. While this is not a conduct issue, it would assist the effective operation of these contractual fallbacks if the authorities were able to provide guidance on determining the rates that should apply. This will be important to increase certainty and reduce litigation risk for issuers or their agents, where multiple alternatives or conventions might be available, for example compounded overnight SONIA, simple average overnight SONIA or a forward-looking term option. To further increase certainty for market participants and market stability, it would be ideal for the relevant successor rates to be available on a screen page or similar and endorsed by the authorities.

However, if this approach was to be pursued, there are some important considerations to be borne in mind. The RFR WG notes that any guidance would need to take into account different market segments as per the work of the RFR WG's Use Case Task Force, as well as the approaches being taken in other jurisdictions, particularly where products or programmes are multicurrency. It is also important to remember that some fallback language not only addresses cessation events but also pre-cessation events and early opt-in triggers, which would have an impact on when the fallback is triggered and therefore potentially on the appropriate spread methodology.

We are aware that, across a broad range of products, the sophistication of customers will vary from those with relatively low levels of financial capability to the highly sophisticated. For example, LIBOR is used in mortgages and other simple bilateral loans as well as in more complex products such as trade finance and floating rate notes. The industry would welcome as much clarity as possible from regulators with regards to their expectations around how legacy contracts should be handled, including whether there are different expectations or additional considerations that should be given to specific segments or types of consumers (e.g. Small to Medium Enterprises or retail consumers). While recognising the mandate of the RFR WG is to catalyse transition to SONIA, we would also like clarity on whether alternatives, such as base rate or simple fixed rates for the full term, are acceptable for some consumers.

(b) **Client communications**

The RFR WG is actively supporting adoption of SONIA as the replacement for LIBOR in Sterling markets. However, firms are currently concerned with how to appropriately communicate with clients about SONIA, and in some cases by the prospect of advising clients to move to alternative products while the development of market solutions is still underway e.g. market conventions and the production of a forward-looking SONIA term rate.

The speeches and statements to date from working groups and regulatory bodies, including the FCA, have been helpful in highlighting the criticality and impact of the transition. Some firms have used material from these to provide clients with initial background information on the transition. However, until wider transition protocols and conventions are agreed and more detailed industry timelines developed, the speed with which firms update their clients will be limited.

The RFR WG would encourage regulators to continue to publish regular updates, and would welcome guidelines or expectations on the reasonable steps firms should be taking to ensure customers receive the appropriate communications throughout the transition.

It is particularly important that smaller market participants and their clients are sufficiently sighted on developments and regulators' expectations. Feedback from industry suggests that awareness and understanding of the regulators' messaging around LIBOR varies widely among market participants. Many firms are unclear as to what is being expected of them and find it particularly challenging to plan for LIBOR's discontinuation while discussions around key considerations to the transition are still ongoing. We would therefore encourage the FCA to consider how industry engagement and reach could be improved to ensure all market participants are receiving consistent messages. This could include a communication plan targeted at end customers to ensure they are receiving consistent messages.

(c) **Disclosure – Key Investment Documents (KIDs)**

The PRIIPs Regulations require manufacturers of PRIIPs to provide a Key Information Document (KID) to retail clients and to update the KID when a change significantly affects the information therein. The RFR WG seeks clarification as to whether authorities have any guidance on how to interpret existing legal requirements, or have specific expectations beyond those requirements, when a LIBOR-based contract is amended to include a fair LIBOR replacement rate and / or for legacy contracts that assume LIBOR will continue beyond 2021.

(d) **Acting in the client's best interests when acting as agent on a client's behalf.**

Whilst the RFR WG is committed to supporting the industry's transition away from LIBOR to SONIA, asset managers as fiduciaries must balance the overarching drive toward the new RFRs with the requirement to always act in their clients' best interests.

Presently, there is limited liquidity in many SONIA based instruments and derivatives and as such, there are a range of considerations that need to be made when investing in non-LIBOR based instruments and divesting from LIBOR-based instruments, despite LIBOR's impending end date. As the market for SONIA instruments matures, so that liquidity deepens and pricing improves, it will become easier for asset managers and other firms acting as agent for clients to be satisfied that it is in the best interests of their clients to make the move into those SONIA products.

We would welcome early guidance from the FCA on how firms should assess their obligations to act in the best interests of the client against the need to transition away from LIBOR by end-2021.

(e) **Market conduct and conflicts of interest**

The information regarding transitioning specific clients to new SONIA based products, combined with wider market insight regarding significant positions, may lead to specific conflicts for firms as well as giving rise to potential market abuse risks.

In addition, the relative liquidity of RFR products compared to LIBOR products over the period of transition may provide an opportunity for pricing biases and potentially abusive behaviours to emerge. It may also impact the extent to which relevant transactions are available in the administration of interest rate benchmarks.

The RFR WG members are aware of current Market Abuse requirements, and that client-facing market participants should not be seeking to profit from the industry transition. The RFR WG seeks the development of best practice guidelines as to how firms should handle the conflicts and wider Market Abuse considerations that are potentially inherent in the transition away from LIBOR.

<u>Conclusion</u>

The matters raised in this letter pertain to the FCA's regulatory purview, but are also global in nature. We would like, therefore, to take this opportunity to encourage international coordination and alignment in the regulatory treatment of transition across relevant jurisdictions and different benchmarks.

The RFR WG continues to work to catalyse a broad-based transition to SONIA and looks forward to continued dialogue with the FCA as needed to facilitate this transition.

Kind regards

Tushar Morzaria