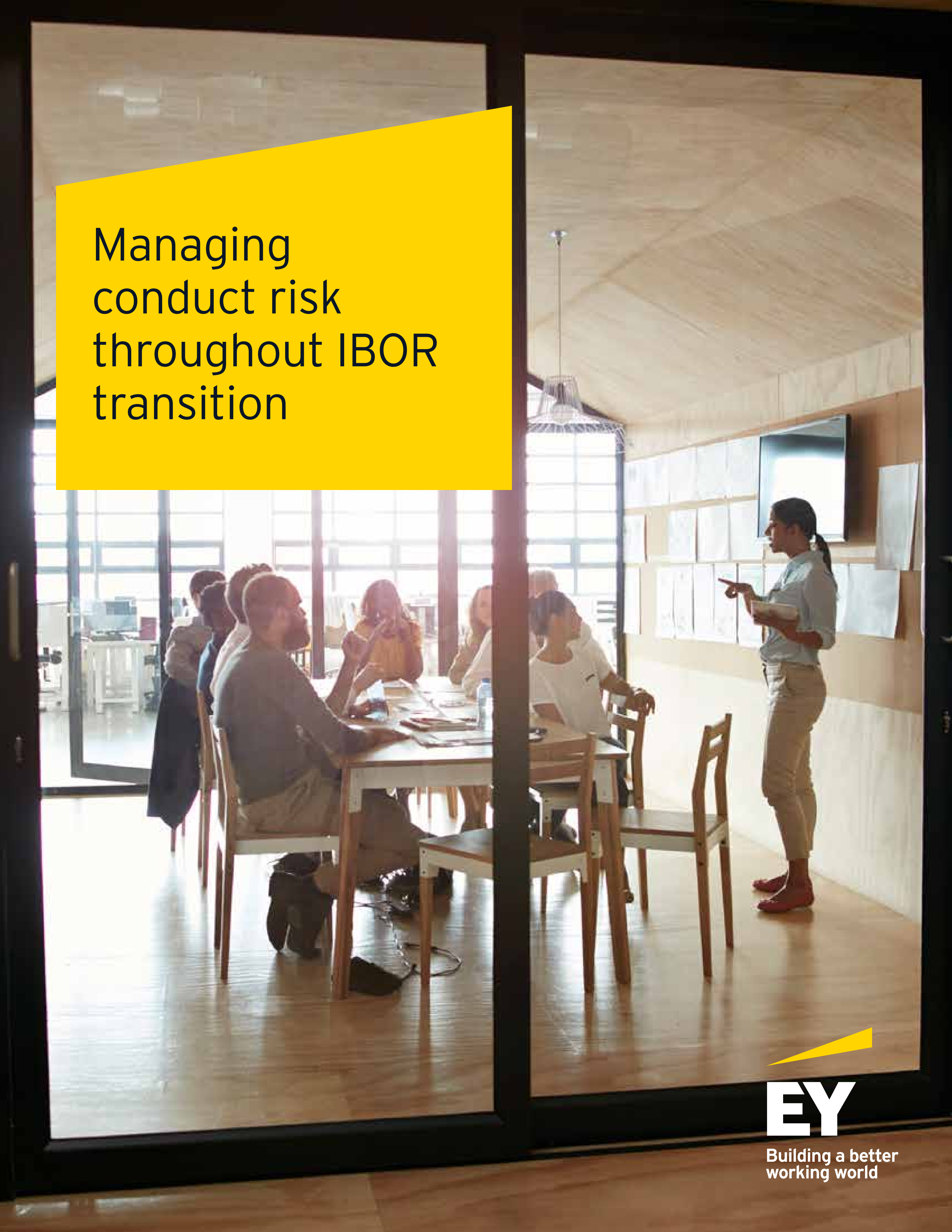
Managing conduct risk throughout IBOR transition



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Introduction

The London Interbank Offered Rate (LIBOR)[1] is extensively used as a reference rate in a range of financial products and instruments including derivatives, floating rate notes (FRNs), securitizations, and business and consumer loans. After more than 40 years of the financial services industry relying on interbank offered rates (IBORs) as a key financial benchmark, LIBOR and other IBORs are being replaced by alternate reference rates (ARRs). In a recent paper published by the Bank of International Settlements, the authors estimated that approximately US$400 trillion worth of financial contracts referenced LIBOR in one of the major currencies.[2]

Given the breadth and depth of the reference rate market, the transition from IBORs to ARRs is one of the most significant changes for the financial services industry. The scale of this industry-wide transition will pose considerable challenges and risks to both individual institutions and the market at large.

One of the major risks that impacts market participants is conduct risk. The focus on conduct risk was heightened in September 2018 when the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) sent a letter, commonly known as the "Dear CEO" letter, to the CEOs of large banks and insurance companies requesting information related to their preparation to transition from IBORs to ARRs. As part of this request, they asked participants to summarize their assessment of key risks, including conduct risk, across a range of transition scenarios.

Since the initial FCA/PRA outreach, a number of global regulators have issued similar requests to financial services firms within their jurisdiction. Regulators have asked firms to provide an overview of financial and contract exposure to IBORs, key risks of IBOR transition, program governance and an implementation road map. Some regulators have specifically asked firms to provide an assessment and quantification of conduct risk (in the context of IBOR transition) and define any mitigating actions. Furthermore, the FCA published a paper in November 2019 exploring drivers of conduct risk and recommendations on how firms should manage this risk.

This article expands upon the topics set out by the FCA and provides an overview of conduct risk, its relevance in the context of IBOR transition and what firms can do to address it as the transition approaches.

What is conduct risk?

Although there is not a common definition across the industry, the FCA has referred to conduct risk as:

> "... the risk that firm behavior will result in poor outcomes for customers."[3]

Conduct risk can be driven by overlooking customers' interests. While outcomes for customers may be obvious, conduct risk may also result in significant repercussions for firms themselves. For example, misconduct may lead to financial loss, reputational damage, significant decline in market capitalization, heightened scrutiny from the regulators and supervisors, and potential constraints on business growth.

A conduct risk case study: interest rate hedging product misselling

One example of how conduct risk resulted in poor outcomes for customers, financial repercussions for banks and regulatory change was the widespread misselling of interest rate hedging products (IRHPs) in the United Kingdom (UK). IRHP-covered products used to hedge underlying customer loans and included swaps, caps, collars and structured collars.

This product was mis-sold for well over a decade; however, banks and brokers sold this product without fully explaining the basis of costs or the operation of the product to their customers. It was often sold as a condition of the underlying loan for customers to buy these products.

In 2012, the Financial Services Authority (FSA) determined that these products had been mis-sold and required the nine participating banks to conduct an independent review of all sales since 2001. In order to address the most relevant customer base, the FSA created a sophistication test that was specific to the IRHP review. This meant that firms could not solely rely upon their existing customer classification process to determine the redress population.

At the conclusion of the review in 2018, 13,900 customers had received compensation totaling £2.2b[4] for damages, with an additional £509m having been paid to customers as a result of the consequential loss emanating from missales. Banks also had to set aside money to cover the costs of terminating customers' IRHPs early in addition to the significant costs realized from carrying out the reviews.

The FSA summarized lessons learned from the review, which included a failure to ascertain customer understanding of risk, poor disclosure of exit costs, non-advised sales where advice was provided, overhedging, and banker rewards and incentives as drivers of sales.

This is just one of many examples of how conduct risk can lead to catastrophic results for customers and banks if not properly handled.

Conduct risk not only impacts customers and counterparties, but can also undermine the integrity of the market, which creates lasting ripple effects as evidenced following the LIBOR scandal. Managing conduct risk, at a firm-level and collectively as an industry, is critical for well-functioning, fair, orderly and transparent markets.

Since the global financial crisis (GFC), there has been a significant focus on restoring the trust and integrity in financial markets. Laws and regulations such as the Dodd-Frank Act and MiFID II were established to strengthen the financial condition of the industry and improve governance and controls. Market participants spent hundreds of billions of dollars expanding their governance, risk and compliance functions in order to strengthen controls and better oversee conduct-related issues.

Despite these efforts, there have been numerous incidents of misconduct in recent years. In the United States and Europe alone, banks have been fined US$342 billion since 2009[5] for issues related to misconduct, and a significant portion of these fines was driven by the manipulation of LIBOR, and other critical financial benchmarks.

Background on LIBOR reform

LIBOR was established as an indicative measure of the average rate at which banks would borrow in the interbank market. LIBOR quotes are published across five currencies and seven tenor points based on submission from panel banks.

In the aftermath of the global financial crisis, global regulators created disincentives for heavy reliance on wholesale unsecured funding, thereby resulting in a significant decline in interbank liquidity. Hence, the LIBOR submission by panel banks was increasingly based on expert judgment and not informed by transactions in the interbank market.

In addition to the declining interbank market, an investigation was launched in 2012 on the attempted manipulation and false reporting of LIBOR rates. These investigations led to more than US$9b in regulatory fines and resulted in global benchmark reform initiatives including a change in the benchmark administrator, a change in the LIBOR calibration methodology and stronger internal controls at panel banks.

A decade after the financial crisis, conduct risk is still at the top of regulators' agendas:

Table 1: Conduct risk agenda

Date	Regulator	Description
2016	Consumer Financial Protection Bureau (CFPB) and Office of the Comptroller of the Currency (OCC)	Strengthened customer protection requirements in the US
May 2017	Financial Stability Board (FSB)	Published a report summarizing conduct risk mitigation efforts throughout the industry
Jan 2018	European Commission	Adopted MiFID II–improved transparency and stricter controls on market processes
Apr 2018	FCA	Published conduct risk framework: "5 Conduct Questions"

While the industry has made significant strides in restoring trust, firms still haven't developed a proactive, comprehensive and cost-effective approach to identify, monitor and manage conduct risk across sprawling global operations. EY anticipates the challenges to oversee conduct risk and the heightened focus on conduct to persist, making it imperative that firms develop sound mitigation strategies to avoid negative repercussions. Further, firms are reassessing culture, and addressing fundamental issues related to culture and incentives to proactively mitigate future conduct risk issues.

Why does conduct risk matter for IBOR transition?

The scale and complexity of the activities required to transition from IBORs to ARRs has potential to increase conduct risk for financial market participants. Transition activities, such as amending or transitioning legacy contracts and the determination of term and credit spread adjustments, will require market-wide collaboration, and without careful planning, can result in negative client and counterparty impact, adverse value transfer and an erosion of trust in the market; however, market-wide collaboration to help ensure smooth and orderly transition is expected to be constrained by potential anti-trust or collusion considerations, especially on issues related to pricing.

Legal, conduct and reputation risk are intrinsically intertwined in the context of transition from IBORs to ARRs and need to be balanced with potential financial risk for the firm.

For example, for a legacy bilateral business loan referencing USD LIBOR, the borrower may be willing to transition the loan to the Secured Overnight Financing Rate (SOFR) with an appropriate spread adjustment so long as the total cost of borrowing does not increase (i.e., value neutral). Although the lender can ensure the transaction is value neutral at the point of transition, it will be difficult to ensure that the transaction is value neutral in the future and across all economic and interest rate scenarios.[6]

Some regulators have formally communicated the need to identify and manage conduct risk. In response to the FCA's "Dear CEO" letter the FCA published feedback noting that,

> "The strongest responses considered a range of conduct risks, including management of potential asymmetries of information and the potential for conflicts of interest, when forming and reviewing their transition plans."

In this response, the FCA stated the importance of market participants implementing targeted controls and taking mitigating actions to address these risks in their planning.

Similarly, in Switzerland, the Swiss Financial Market Supervisory Authority (FINMA) requested information from institutions on whether a compressive assessment has been performed on reputational and conduct risks.

We anticipate regulators will continue to focus on conduct risk throughout the transition, so firms must be proactive in identifying and managing conduct risk.

Even if LIBOR is available after 2021, its use may not be permitted, or it may only be permitted conditionally (e.g., for a limited time for legacy transactions) by the regulators. Alternatively, regulators may deem LIBOR to be an unrepresentative benchmark thereby resulting in a pre-cessation trigger. As part of an institution's conduct risk assessment and scenario analysis, it will need to think through its mitigating action plan, and communication strategy ahead of the cessation event.

What will drive conduct risk throughout the transition?

Various forms of conduct risk may arise throughout the transition; however, there are seven key risk drivers that firms should focus on addressing:

1. Failure to adopt robust fallback language in new contracts
2. Continued origination of new IBOR-linked contracts maturing post-2021
3. Basis risk resulted from varying fallback language
4. Value transfer resulted from transition or amendment to legacy contracts
5. Selection of an ARR that is not endorsed by the National Working Group/Official Sector
6. Failure to confirm that the replacement product meets the needs of the customer and is understood by the customer
7. Failure to identify and manage potential areas of market manipulation and establish mitigant controls

1. Failure to adopt robust fallback language in new contracts

Fallback language in contracts refers to the provisions that lay out the process through which a replacement rate can be identified if a benchmark (e.g., USD LIBOR) is not available.

The fallback language included in most IBOR-linked contracts today has many shortcomings. Typically, it was written to provide an interim solution should a rate be temporarily unavailable, rather than address a permanent cessation. Furthermore, fallback language can be silent or lack clarity around selecting replacement rates and can result in contract frustration and economically undesirable outcomes for customers. Customers may claim that they were not made sufficiently aware of the risks of the transition, while the financial services provider was fully aware and did not take appropriate action. This could not only result in financial repercussions, but also reputational damage.

To mitigate conduct risk, market participants must include robust fallback language in all new transactions, whether they are referencing IBORs or ARRs.

To mitigate the potential conduct risk associated with an IBOR cessation, it's imperative that firms begin to include robust fallback language in new transactions.

To create consistency across the industry and facilitate a smooth transition, industry bodies have been working to develop robust fallback language for IBOR-linked contracts. For over-the-counter (OTC) derivatives, the International Swaps and Derivatives Association (ISDA) plans to amend the ISDA 2006 Definitions. For cash products, national working groups, such as the US-based Alternative Reference Rates Committee (ARRC), have published proposed fallback language to implement new transactions referencing IBORs.

We recommend that institutions adopt the fallback language proposed by ISDA, the ARRC and other national or industry working groups at the earliest possible opportunity. Financial market participants should not wait for perfect or consensus fallback language to emerge but seek to iteratively improve fallback language for new contracts. Firms should also plan significant client outreach, communication and education efforts in 2020 to help ensure informed acceptance of robust fallback language across cash and derivatives by clients and counterparties.

For contracts referencing ARRs, robust fallback language should also be introduced to avoid transactions being exposed to the same benchmark cessation risks in the future. Because the industry-proposed fallback language was written to address an IBOR cessation event and trigger a fallback to ARRs, it is not meant to be included in new ARR-linked contracts. Market participants must develop or modify the fallback language for use in these contracts.

2. Continued origination of new IBOR-linked contracts maturing post-2021

Although ARR market adoption is gaining momentum, institutions continue to write long-dated contracts referencing IBORs, increasing the population of impacted contracts and compounding their transition and conduct risk exposure. With the FCA stating that "you need to be prepared for an end date for LIBOR in 2021,"[7] firms cannot rely on IBORs existing post-2021[8] and must plan for the risks associated with a permanent cessation.

When IBORs cease to exist, fallback provisions will determine how IBOR-linked contracts are handled. Because fallback provisions were typically designed to only address short-term disruptions of IBOR, the economics of the contract can substantially change. For example, many floating rate notes (FRNs) fallback to the last IBOR fixing, effectively turning the product into a fixed rate note, which may have adverse impacts for the issuer or investor.

To mitigate the conduct risk associated with an IBOR cessation, some firms, particularly in the UK, have committed to stop writing IBOR-linked contracts in the near future and use the Sterling Overnight Interbank Average Rate (SONIA) as the benchmark. Furthermore, the FCA noted on 21 November 2019 that it is encouraging banks to stop offering LIBOR-based swaps from the first quarter of 2020.

> “
> In sterling interest rate swap markets, we will be encouraging market-makers to make SONIA the market convention from Q1 2020.[9]

In the US, the Federal Housing Finance Agency (FHFA) instructed the Federal Home Loan Bank (FHLB) not to enter in any new financial assets, liabilities or derivatives that reference LIBOR by 31 March 2020, and to stop purchasing investments referencing LIBOR by 31 December 2019.[10] In addition, some asset managers are in the process of implementing investment policies that prevent them from buying IBOR-linked instruments unless they're supported by robust fallback language.

Other regions have not had the same level of commitment to stop issuing IBOR-based products and financial instruments, and IBOR-linked issuances continue to grow every day.

For a typical US-based global systemically important bank (G-SIB), about 25% to 40% of its IBOR financial exposure matures post-2021. While commercial loans tend to be short-dated, a significant portion of consumer loans linked to IBOR in the US mature post-2021. The ARRC's Second Report stated that roughly 80% of currently outstanding business loans will mature by the end of 2021, but only around 57% of retail mortgages will mature by that date. Furthermore, few of the SOFR issuances to date have maturity dates post-2021. One of the challenges preventing firms from issuing long-dated SOFR contracts is the inability to effectively hedge risks as the SOFR derivatives market is still in a nascent stage.

To mitigate conduct risk associated with continuing to issue IBOR-linked contracts post-2021, firms should undertake the following activities:

1. Monitor new and legacy issuances of IBOR-linked exposures maturing post-2021 on an ongoing basis
2. Include recommended fallback language proposed by national working groups and trade associations in new IBOR-linked contracts
3. Set a date to stop issuing IBOR-linked contracts by product and agreement type
4. Set a cap on maturity profile of IBOR exposure, if possible
5. Perform client outreach and implement risk disclosures to inform the end users on the potential cessation of IBORs after 2021

3. Basis risk resulted from varying fallback language

While industry efforts to develop robust fallback language are a critical step to enabling a harmonized transition, there are still risks involved in adopting the proposed fallback language. Fallback language varies between derivatives and cash products and, even further, among different cash products. This variation drives uncertainty and may result in increased basis and conduct risk.

One of the main drivers of basis risk is the difference in the fallback waterfall between cash products and derivatives. For cash products, the ARRC's endorsed language includes a fall back to term SOFR, if available, whereas derivatives fall back to a compounded overnight SOFR. If the fallback provisions in a cash product and its underlying hedge are triggered, they could reference differing variations of SOFR, which could result in hedge ineffectiveness. This may require the customer to re-book hedges, which could be costly and result in conduct and reputational risk to the financial institution.

Basis risk is also driven by differences in fallback triggers between cash products and derivatives. The fallback language for cash products includes a series of triggers prior to the benchmark being discontinued (e.g., if a regulator considers LIBOR to be unrepresentative). These were likely included for cash products because of the difficulty in obtaining the required consent to amend a contract should LIBOR continue to be published but no longer be representative. Pre-cessation triggers, however, were not initially proposed for derivatives, where fallback language is only triggered upon the discontinuation of the benchmark. This poses a risk for the fallback provisions in a cash product and its underlying hedge to get triggered at different times. This would result in hedge ineffectiveness, additional costs to the customer and basis risk. For example, a set of contracts that are linked due to a hedging relationship may be risk neutral when linked to LIBOR, but if the fallback language is triggered for the cash product but not its underlying hedge, this could generate material basis risk for the client and financial institution.

To address these concerns, in May 2019, ISDA launched a consultation that sought comments on how derivatives contracts should address a regulatory announcement that LIBOR, or other IBORs, are no longer representative of the underlying market. On 9 August 2019, ISDA published a statement summarizing the preliminary results of the consultation. ISDA received 89 responses and noted that respondents expressed a wide variety of views regarding whether and how to implement a pre-cessation trigger related to "non-responsiveness."

Furthermore, on 19 November 2019, the Co-Chairs of the FSB's Official Sector Steering Group (OSSG) published a letter encouraging ISDA to add a "pre-cessation" trigger alongside the cessation trigger. The FSB noted that "this would help reduce systemic risk and market fragmentation by ensuring that as much of the swaps market as possible falls back to alternative rates in a coordinated fashion."[11]

To mitigate these risks, market participants should analyze the potential impact of varying fallback waterfalls and triggers on their organization. They should identify and assess all contracts that are linked due to a financial arrangement, and proactively communicate the risks of a hedge mismatch to their customers when adopting new fallback language.

Basis risk may also arise between cleared and uncleared derivatives as a result of the transition of discounting and price alignment from EFFR to SOFR on 16 October 2020. It also may arise from the lack of universal adherence to ISDA fallback protocol across all clients and counterparties.

To mitigate basis risk resulted from varying fallback language, firms should undertake the following activities:

- Analyze the potential impact of varying fallback waterfalls and triggers on their organization
- Identify and assess all contracts that are linked due to a financial arrangement
- Proactively communicate the risks of a hedge mismatch to their customers when adopting new fallback language

4. Value transfer resulted from transition or amendment to legacy contracts

One of the largest IBOR transition risks facing market participants is the potential for value transfer when transitioning or amending legacy contracts referencing IBOR.

When amending the base rate of a contract from an IBOR to an ARR, there is potential for the underlying value to shift from one party to another. This is largely due to variances between the rates, including differing term structures and credit premiums, which may cause a customer to pay more or receive less after the contract has been amended. In this scenario, customers may claim that they were treated unfairly. If the financial provider is a member of an RFR working group, the customer may claim that their counterparty had insight that led them to take advantage of its customers. In this case, attorneys may argue that the customer should be compensated with a payment that is reasonable and consistent. This scenario could be further exacerbated if dealers and lenders are perceived to be collaborating in the selection of the ARR, fallback language or spread adjustments.

Value transfer can also occur when fallback language is triggered, potentially leading to gains or losses on either side of the contract. This could result in substantial litigation costs and reputational damage, which can impact a firm's competitive position. Because of this, market participants should not be overly reliant on fallback terms as a transition strategy for legacy contracts.

It is important that firms focus on fair outcomes for their customers and develop robust communication strategies to prevent scenarios of information asymmetry leading up to the transition.

The need for robust communication is not just limited to banks acting as issuers and lenders. For example, if a bank is acting as the administrative agent, it is still subject to conduct risk and should make its customers aware of the transition and associated risks of moving to the ARR. Similarly, asset managers are at risk of misconduct and must maintain fiduciary responsibilities toward their customers in instances where the portfolio includes floating rate instruments referencing LIBOR. Avoiding scenarios of information asymmetry will be paramount to reducing the risk of misconduct.

5. Selection of an ARR that is not endorsed by the National Working Group/ Official Sector

Another key driver of misconduct results from the use of an ARR that is not endorsed by the National Work Group (NWG) and administered by the Official Sector and is not deemed to be in compliance with International Organization of Securities Commissions principles. Some institutions may be interested in selecting other rates, such as USD ICE Bank Yield Index (BYI), due to the availability of term rates, and similar characteristics as LIBOR. In some segments and products, use of an alternative benchmark other than the one endorsed by the NWG may be reasonable and may accelerate the transition away from LIBOR. For example, in the community banking and lending markets in the US, we may see a resurgence of the Prime Rate as an alternative benchmark that is well understood by mid-market borrowers and may not require significant changes to operations and systems.

When selecting a benchmark other than the National Working Group-endorsed ARR, a firm should carefully evaluate the risks and benefits associated with the rate, and how it may impact its customers. In assessing the suitability of the rate, the firm should strike a balance between its financial objectives, and financial outcomes for its clients and counterparties. We recommend that the Corporate Treasury function conduct a comprehensive assessment of potential alternate benchmarks and provide guidance to the business lines on the permissible use of a benchmark. Alternatively, use of a benchmark by the business line not supported by the Corporate Treasury function and the funds transfer pricing (FTP) framework may lead to undesirable basis risk for the business line.

6. Failure to confirm that the replacement product meets the needs of the customer and is understood by the customer

The lessons learned from previous remediation programs suggest that significant conduct risk arises from the way in which the transition engagement with the client is managed. Conduct risk may vary based on the level of information provided to the customer, the sophistication level of the customer, the extent to which information is provided, especially in a "non-advised" scenario, and the level of training provided to relationship managers.

Firms should establish a conduct risk assessment framework to identify all potential conduct risks and then determine the relevant mitigants, which may vary by client cohort. Existing conduct risk frameworks can be leveraged as a starting point; however, most frameworks do not go to the level of detail necessary to identify specific risks posed by the IBOR transition and the potential customer outcomes.

As the transition process develops, it is likely that customer needs and responses will develop into patterns, which will require the firm to respond appropriately. It is therefore critical that there is an effective governance and management information framework that can provide management with a clear picture of the emerging thematic issues.

7. Failure to identify and manage potential areas of market manipulation and establish mitigant controls

In the FCA's feedback on the responses received to its "Dear CEO" letter, it states one are of concern to be that some firms …

> "… did not acknowledge the potential risks from market manipulation and insider trading."

The IBOR transition process is likely to create a significant reconfiguration within banks' trading books, potentially over an extended period of time. The scale and uncertainty that this might bring is causing regulators to seek clarity from market participants as to where market conduct issues may occur and how they are managing that risk.

The expectation is that market participants will consider when and how they rebase their books, and how they will manage information flows within their organization. Participants will need to review the scenarios within their surveillance programs and enhance them to manage the specific risks posed by IBOR transition. This may include the establishment of new scenarios or surveillance processes.

While this has not yet been a feature of many IBOR transition programs, it is clear that the FCA and other regulators will expect firms to identify these risks and implement mitigating actions.

How can institutions manage and mitigate their conduct risk?

To identify, measure and mitigate conduct risk associated with transitioning from IBORs to ARRs, firms must consider all customer touchpoints throughout the transition to make sure that customers are not adversely impacted. They must also look internally at their product design, sales and post-sales processes to confirm that they are focused on generating positive customer outcomes.

Before conducting a risk assessment, firms should first define what conduct risk means to their organization. Regulators, such as the FCA, have not published official definitions of conduct risk as they believe it is critical for organizations to define it themselves as part of their risk programs. A study published by Thomson Reuters noted that only 27% of firms in North America had a working definition of conduct risk in 2017.[12] Firms should think through all aspects of conduct risk, including possibilities of harm to customers, market integrity and competition. Once a clear definition has been agreed to, firms should adopt it globally so that each business unit is aligned on the same mission.

Risk identification

While many firms have clear frameworks to identify certain types of risk, such as financial risk and operational risk, conduct risk can be more challenging due to the variety and idiosyncrasy of its drivers. Furthermore, conduct risk drivers are sometimes highly correlated, making it even more difficult to build predictive models from an independent set of variables. Because of these challenges, firms typically leverage backward-looking approaches, such as reviewing customer complaints, but these do not diagnose the root of the issue and are often identified too late. Firms should instead focus on forward-looking indicators of conduct risk. For example, market participants can develop analytic capabilities to understand cross-currency and cross-product exposures for each client, which can be used to identify potential areas of basis risk upon transition.

Firms have also struggled to create a front-to-back view of conduct risk. While some firm's risk assessments are owned by corporate risk or compliance teams, there should be strong accountability from the businesses. Conduct risk can arise throughout a customer journey, with product development, sales, execution and reporting being the primary risk areas. Because of this, it's critical for firms to take a business-driven approach to identify conduct risk across the value chain. In the FCA's "5 Conduct Questions" study, it noted that the most successful approach to identifying conduct risk is one where individual business units are responsible for assessing their own business and processes, often at the desk level, to identify their conduct risk exposure. These metrics and exposures should be aggregated and reported to senior management, so they can monitor enterprise-level exposures and identify trends that may lead to misconduct.

Business units can go about conducting this assessment by defining their various customer journeys throughout IBOR transition, and the processes and activities required to support each journey. They can then evaluate how each transition scenario can impact customer outcomes across each touchpoint, and what levers they can adjust to create positive outcomes.

Risk measurement

Once conduct risks inherent in the LIBOR transition have been profiled across each business and customer segment, firms should develop an effective method of measuring this risk throughout the transition.

One method that should be leveraged is exposure-based modeling. For example, firms should monitor their LIBOR exposure over time to track their transition of products to alternative reference rates and make sure business units are not continuing to write long-dated LIBOR-linked contracts, which may increase their conduct risk. This data should be readily available to the front office, so it can influence their behaviors. Exposure modeling can also be used to measure conduct risk across individual product types. For example, by establishing risk profiles by customer segments and products, a firm can measure their conduct risk exposure for a product as their mix of IBOR and ARR-linked products changes. Certain customer segments, such as smaller corporates, may be more likely to initiate claims of mis-selling, while certain products, such as syndicated loans, require more complex amendment mechanisms. With risk profiles established, firms can estimate potential litigation costs, reputational damage and financial losses.

Institutions should also look to quantify key risk indicators where possible. Advanced analytics techniques, such as machine learning, can now be leveraged to provide cohesive insights around conduct risk. Firms can compile data throughout the customer journey, including sales data, market surveillance and customer feedback, and use machine learning algorithms to identify behaviors that may create conduct risk.

Risk mitigation

There are several preventative measures that firms can take to mitigate conduct risk throughout IBOR transition. These include developing a clear policy framework, a comprehensive communication strategy and a robust product governance model.

A structured IBOR transition policy framework can be leveraged to instruct business units on how to respond to various transition scenarios. For example, if a customer is not cooperating in a bilateral negotiation, a firm should have a clear policy on how to respond across each product and customer segment. Another policy might dictate a date when a business must cease to issue LIBOR-based contracts. These types of policies will drive consistency and accountability, and reduce conduct risk throughout the transition.

As discussed in the section on risk drivers, conduct risk is likely to be caused by information asymmetries between an institution and its customers. To mitigate this risk, firms must develop comprehensive communication strategies that are consistent across their organizations but tailored to the sophistication of customer segments and complexity of products. Firms should first conduct proactive outreach to their customers to provide concise and consistent messaging around the transition process and proposed timeframes. They must also confirm their customers understand the characteristics and risk profiles of the new products being offered, particularly for less sophisticated retail customers or small corporates, who may have less awareness and bargaining power. Customer-facing staff should be trained and provided with reference guides to drive consistent language across businesses. Finally, firms should review their marketing and sales processes, include clear disclosures and take customer suitability into consideration. For example, when issuing FRNs tied to LIBOR, the prospectuses should include risk factors related to the cessation of LIBOR.

Unfavorable customer outcomes can be rooted from poor judgment throughout the product development and sales life cycle, beginning with product design. When designing products referencing ARRs and going through the new product approval process, firms should take into consideration the customer's perspective and potential outcomes. Because the characteristics of ARRs are different from IBORs, rigorous product governance and controls should be established throughout the transition. This should include specific dates for when businesses should stop selling IBOR-linked products, as well as a road map to amending legacy contracts and adopting ARRs in new contracts.

Summary

Failure to adequately identify and manage conduct risks when transitioning from IBORs to ARRs can result in adverse consequences to financial market participants including reputation, regulatory and conduct risk. Institutions must act now to develop a comprehensive conduct risk program that aims to make sure clients are treated fairly throughout the transition. Institutions must proactively balance market opportunities and financial risks during the transition process with legal, reputation and conduct risk.

As David Ramsden concluded in his speech on 5 June 2019,

> "… the time for 'last orders' is now."

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The views expressed by the authors are not necessarily those of Ernst & Young LLP or other members of the global EY organization.

Footnotes

[1] LIBOR, administered by ICE Benchmark Administration, is published daily for five major currencies (USD, GBP, EUR, JPY and CHF) across seven tenor buckets (35 unique rates for each currency and tenor pair) based on submissions by no more than 16 panel banks. Similar to LIBOR, IBORs are published for a number of other currencies – for example, Hong Kong Interbank Offered Rate (HIBOR) is the benchmark interest rate for Hong Kong dollars and administered by the Treasury Markets Association (TMA).

[2] Andreas Schrimpf, Vladyslav Sushko, "Beyond LIBOR: a primer on the new reference rates," *BIS Quarterly Review*, March 2019, ©2019 *BIS Quarterly Review*. https://www.bis.org/publ/qtrpdf/r_qt1903e.pdf.

[3] FSA Publication no. 004041. *Retail Conduct Risk Outlook 2011*, Financial Services Authority, (accessed via https://www.fca.org.uk/publication/business-plans/fsa-rcro.pdf, 9 June 2019).

[4] FCA, Interest rate hedging product (IRHP), Financial Conduct Authority, 2018 (accessed via https://www.fca.org.uk/consumers/interest-rate-hedging-products, 23 August 2019).

[5] "U.S., EU fines on banks' misconduct top US$400 billion by 2020: report," Reuters, Published September 27, 2017. https://www.reuters.com/article/us-banks-regulator-fines/u-s-eu-fines-on-banks-misconduct-to-top-400-billion-by-2020-report-idUSKCN13mC210B, Accessed August 23, 2019.

[6] For example, if a bilateral business loan is priced at USD 3m LIBOR + 200 bps, at the point of transition the loan may be priced at O/N SOFR + [Term Spread] + [LIBOR-SOFR Basis Spread]. Although this would ensure value neutrality at the point of transition it does not ensure that the contract will be value neutral for the remaining life of the loan.

[7] Megan Butler, "Ending reliance on LIBOR: overview of progress made on transition to overnight risk-free rates and what remains to be done." Financial Conduct Authority, February 2019, ©2019 FCA. https://www.fca.org.uk/news/speeches/ending-reliance-libor-overview-progress-made-transition-overnight-risk-free-rates-and-what-remains.

[8] The Financial Conduct Authority (FCA) announced that it will not compel panel banks to submit LIBOR quotations after 2021. As LIBOR is not guaranteed beyond this date, firms will need to review and potentially remediate any contracts associated with IBOR-referencing transactions that mature post-2021.

[9] Huw Jones, "UPDATE 2-UK urges banks to end Libor-based swaps from early next year," Reuters, November 2019, ©2019 Reuters. https://www.reuters.com/article/libor-regulator/update-2-uk-urges-banks-to-end-libor-based-swaps-from-early-next-year-idUSL2N28108X.

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