SNAPSHOT

LIBOR Transition for Asset Managers - act now to manage the risk

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Why has the LIBOR transition been introduced?

For more than 40 years the financial services industry has relied upon interbank offered rates (IBORs) as a reference rate for certain variable-rate financial instruments. This includes the London interbank offered rate (LIBOR).

Whilst historic compliance issues including charges of attempted manipulation and false reporting have been widely publicised, the more pressing problem relates to a decline in the liquidity of the interbank unsecured funding markets linked to the submissions, which limits the ongoing validity of LIBOR.

This resulted in global regulators proposing that LIBOR, as well as other IBORs, are replaced by alternative reference rates (ARRs) by the end of 2021. The Financial Conduct Authority (FCA) has repeatedly stated that it will not compel banks to submit LIBOR quotations after 2021 and that all market participants, must transition to alternative rates before this date. The regulator has specifically instructed asset management firms to “prepare now for the end of LIBOR”.

Despite the challenges and market volatility resulting from the COVID-19 crisis, which have led regulators to push back the interim deadline for firms to stop issuing new sterling LIBOR-linked lending from Q3 2020 to Q1 2021, the final target date for complete transition to ARRs by the end of 2021 still stands.

Considerations for Asset Managers

The LIBOR transition will be challenging for Asset Management firms to navigate, due to the complexity and variation that exists across asset classes and client types. Reliance on LIBOR is not only present within investments, but also in its use as fund benchmarks, performance targets, pricing models, operational processes and infrastructure. Firms need to account for all of this in their transition plans, as well as identifying and mitigating the associated prudential, legal and conduct risks arising from implementing change of this nature and scale.

Transitioning to the new reference rates will undoubtedly have commercial impacts for a firm and its clients, therefore investment strategies should now incorporate LIBOR transition. Against these strategies, products linked to LIBOR will need to be assessed to determine if they will perform as expected and still meet client needs post transition.

There will be instances where Asset Managers are handling the transition of investments on behalf of their clients. It will be essential that firms act in their clients’ best interest, however, ensuring consistent and fair outcomes for all clients will be complicated, particularly across different product types, client segments and varying fallback language. Clear principles for decision making, as well as robust governance around the transition of investments on behalf of clients will support this, alongside a comprehensive client engagement strategy.

Another key stage of the transition roadmap is deciding when to cease investing in LIBOR-linked products and when to stop launching new products or funds which use LIBOR as a benchmark or performance indicator. This is difficult due to the continued industry uncertainty surrounding the transition to new rates, however continuing to rely on LIBOR increases remediation work and opens-up potential conduct risks. Poor or delayed management of the transition and associated risks could lead to unfair client outcomes and reputational damage.

The FCA issued a ‘Dear CEO’ letter to asset management firms in February 2020 indicating dissatisfaction with the rate of progress made by asset managers to date in preparing for the transition. Some firms need to accelerate their efforts to be adequately prepared for the cessation of LIBOR. The letter reminds asset managers of their responsibility to treat clients fairly and uphold the clients’ interest as they manage the transition of investments held on behalf of clients.

What is the BCS view, and how can we help?

The transition away from LIBOR requires complex change to be delivered against a backdrop of uncertainty. Asset management firms should already be closely managing the transition of their investment portfolios from legacy indices to new ARRs to protect client value. They also have a responsibility to appropriately communicate the impacts of the transition to their clients, and to keep records of the reasonable steps they have taken to ensure clients are treated fairly.

2020 remains a key year for transition to ARRs. All Asset Management firms should have mobilised a transition programme and be executing against a roadmap to meet the FCA timelines. Those behind the curve, risk being unable to transition to ARRs in line with regulator expectations and face reduced liquidity of legacy reference rates.

If you want to have greater confidence in your ability to transition away from LIBOR, BCS Consulting recommends taking the following actions today:

1) Reduce existing LIBOR exposure: Firms should now be actively monitoring their exposure linked to LIBOR and reporting against a plan to reduce it. Changes to fallback language and fund documentation should now be in progress. There should also be a plan to adapt fund benchmarks or pricing and valuation models which reference LIBOR.

2) Identify the conduct risks arising from the transition: Firms must take proactive steps to manage conduct risk and protect their clients’ interests. A clear understanding of these risks and how to manage and mitigate them is key to meeting regulator expectations. For example, introduce governance and controls to ensure that clients are not transferred to inferior rates or contractual terms, or exposed to unreasonable costs, and when using new ARRs, that products still meet client needs.

3) Deliver staff training and client communication: Client facing staff need to understand the implications of LIBOR ending and engage with clients on the topic. Replacement benchmarks and performance targets will also need to be clearly communicated to clients. Proactive communication is better than waiting for client requests or instructions and is key to mitigating conduct risk and increasing demand for new ARR linked products.

4) Engage with industry bodies: Asset management firms are expected to actively participate in market efforts to facilitate the end of LIBOR. Engage with industry bodies to understand market direction on key topics and advocate viewpoints on them.

BCS Consulting can use our delivery, regulatory change and LIBOR expertise to help mobilise, plan and deliver your LIBOR transition programme. We also couple our industry-leading conduct risk experience, with our LIBOR transition expertise to help our clients understand and effectively manage their conduct risk exposure from the LIBOR transition.

Interested to know more?

To find out more about how BCS Consulting can help with your LIBOR transition, please get in touch with one of our key contacts listed below.

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