

Association of Foreign Banks (AFB) & BCS Consulting

LIBOR Transition for your UK Branch

30th January 2020

Prepared by: BCS Consulting



Welcome

Today is the second workshop event jointly hosted by the AFB and BCS Consulting

Our aim is for the workshop to be as engaging, interactive and informative as possible

Please feel free to offer your insight, experience and ideas on all topics – we will be following Chatham House rules

The high-level format for topics during the workshop is as follows:



Who are BCS?

WHO ARE WE?

We are an employee-owned management consultancy committed to delivering excellence in everything we do.

It's a unique position to be in and one that inspires us all to work to the highest standards because OUR business depends on it.

What's good for our business is good for your business because it means that when your customers expect more choice, control, flexibility and value, you can rely on us to help you deliver it.

WE PROVIDE SOLUTIONS ACROSS

RISK & FINANCE

TECHNOLOGY & DIGITAL

PROGRAMME & CHANGE DELIVERY

PERFORMANCE IMPROVEMENT

SOFTWARE

WE WORK IN

RETAIL BANKING

CORPORATE BANKING

CAPITAL MARKETS

INSURANCE

ASSET & WEALTH MANAGEMENT

WHAT DO WE DO?

We provide outstanding consulting solutions for the digital world. Working as trusted partners, our consultants add value to projects from conception to delivery and can blend seamlessly into your existing teams to bring about change and embed it smoothly.

WHERE DO WE EXCEL?

We are focused on Financial Services, specifically Retail and Corporate Banking, Capital Markets, Insurance and Asset and Wealth Management where we can help maximise your potential in today's technology-driven financial landscape.

Introducing the BCS team



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Agenda

1 Introduction and welcome

2 LIBOR transition – background

3 Focus for today

4 Focus 1: Contract discovery, exposure calculations and fallback language remediation

5 Focus 2: Managing conduct risk

6 Focus 3: RFR product readiness

7 Conclusion and wrap up

8 How BCS Consulting can help

LIBOR transition background – why is LIBOR being replaced?



Decline in the **liquidity** within the interbank unsecured funding markets



Charges of **attempted manipulation** and false reporting



Reluctance from **LIBOR panel banks** to submit quotes



Systemic risk due to the uncertainty surrounding the durability of IBORS

The Financial Authority (FCA) has stated that it will not compel banks to submit LIBOR quotations after 2021 and that market participants must transition to alternative rates before this date.

“*The discontinuation of LIBOR should not be considered a remote probability 'black swan' event. Firms should treat it as something that will happen and which they must be prepared for*”

Andrew Bailey, Chief Executive, FCA, July 2019

What are the alternatives to LIBOR?

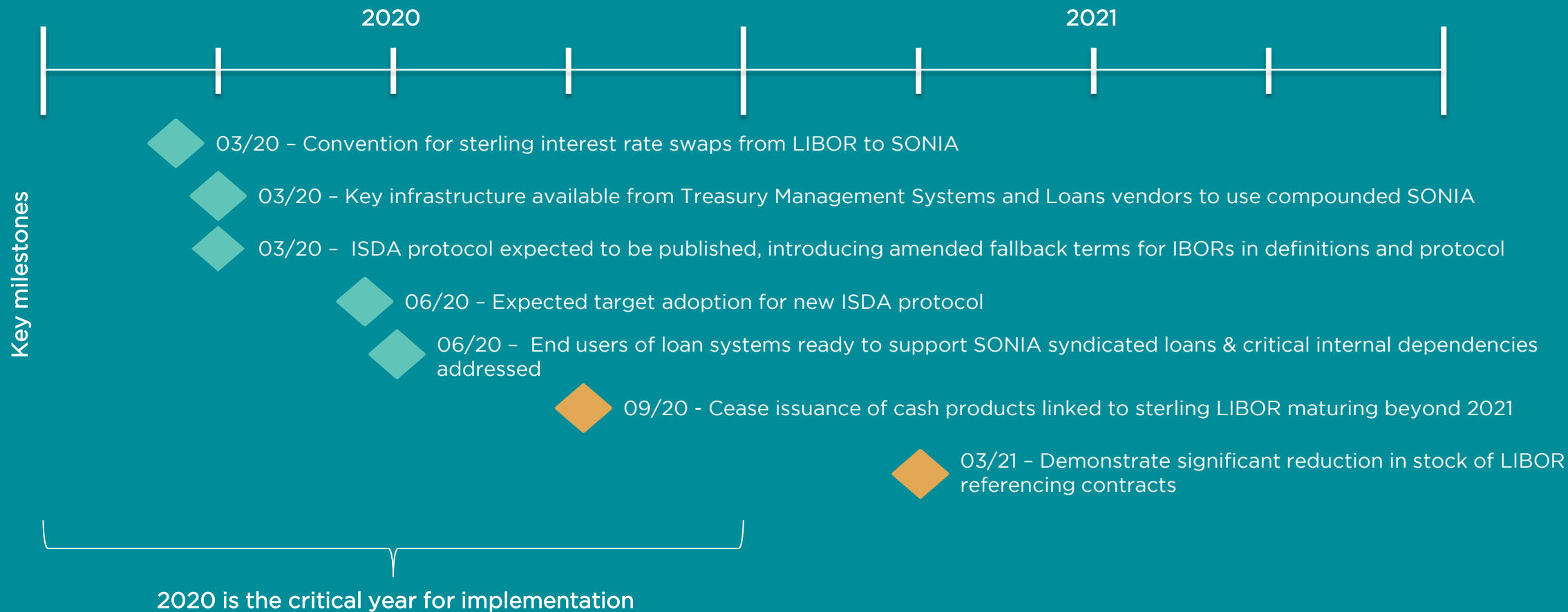
Working groups in the various LIBOR currency jurisdictions have been working on selecting risk-free reference rates (RFRs) as a replacement benchmark for LIBOR.

What is the difference between LIBOR and RFRs?

- RFRs are backward-looking overnight rates based on actual transactions whereas LIBOR is a forward looking term rate
- RFRs are near risk-free rates while LIBOR incorporates credit and term liquidity premiums

Jurisdiction	RFR	Working Group	Description
UK	SONIA: Reformed Sterling Overnight Index	Working Group on Sterling Risk Free Reference Rates (RFRWG)	<ul style="list-style-type: none"> • Calculated based on the rates paid on eligible overnight unsecured deposit transactions • Administered by the Bank of England
US	SOFR: Secured Overnight Financing Rate	Alternative reference rates committee (ARRC)	<ul style="list-style-type: none"> • Based on overnight transactions in the U.S dollar treasury repo market • Administered by the Federal Reserve
Eurozone	ESTR: Euro Short-Term Rate	Working group on risk free reference rates for the Euro area	<ul style="list-style-type: none"> • Based on the wholesale euro unsecured overnight borrowing costs of banks in the euro area • Administered by the ECB
Switzerland	SARON: Swiss Average Rate Overnight	National working group on CHF reference rates	<ul style="list-style-type: none"> • Based on overnight transactions in the Swiss Franc repo market • Administered by SIX
Japan	TONAR: Tokyo Overnight Average Rate	Study group on risk free reference rates	<ul style="list-style-type: none"> • Unsecured and overnight • VWAP of transactions • Administered by Bank of Japan

Regulatory expectations and market developments



What does the LIBOR transition mean for banks?

Remediation of legacy LIBOR-linked transactions that mature after 2021

1

Contract discovery: Identify all contracts with direct or indirect LIBOR provisions

Contract review: Review and update where necessary fallback language in contracts

Replacement rate negotiation: Negotiate new rate with clients when fallback triggers enacted

Contract transition: Transition transactions to agreed replacement rates

Business readiness to offer products, instruments and services referencing new Risk Free Rates (RFRs)

2

Product strategy: Design and agree new products based on RFRs

Processes & systems: Identify and enhance all impacted business processes and systems

Risk & valuation models: Identify and enhance all models required to switch to RFRs

Legal documentation: Identify and enhance contract templates and other related documents

Other Considerations:



Potential financial impact of switching to RFRs



Potential tax and accounting impact of switching to RFRs



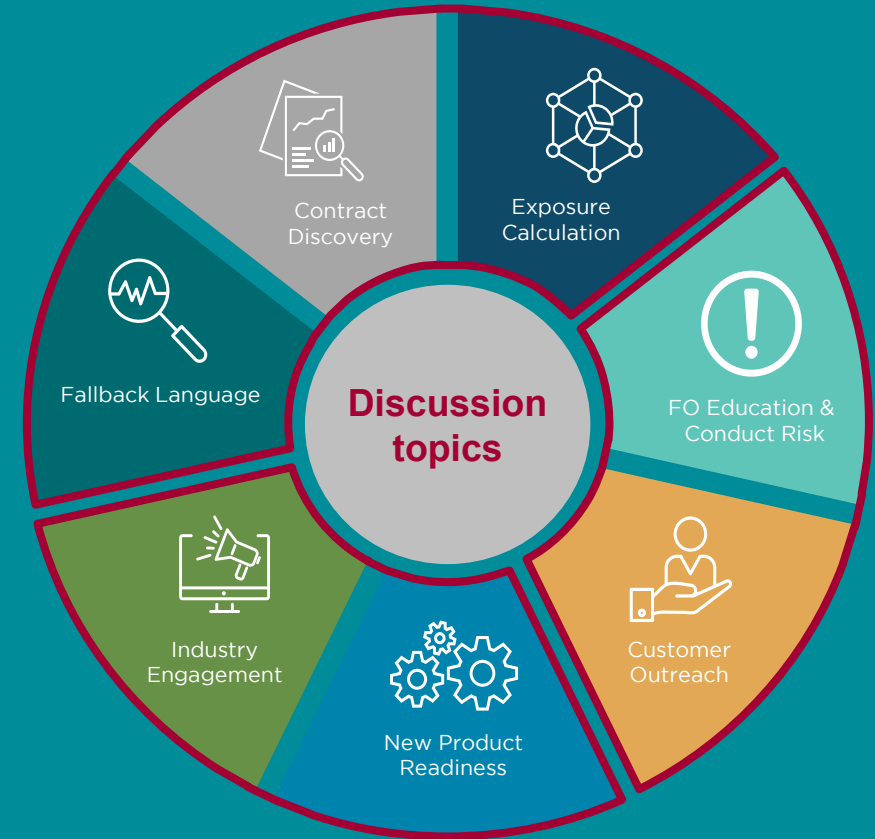
Conduct risk during the transition

What is the focus for today?

The focus of today's workshop is to share insight across key topics we think will be most valuable to you.

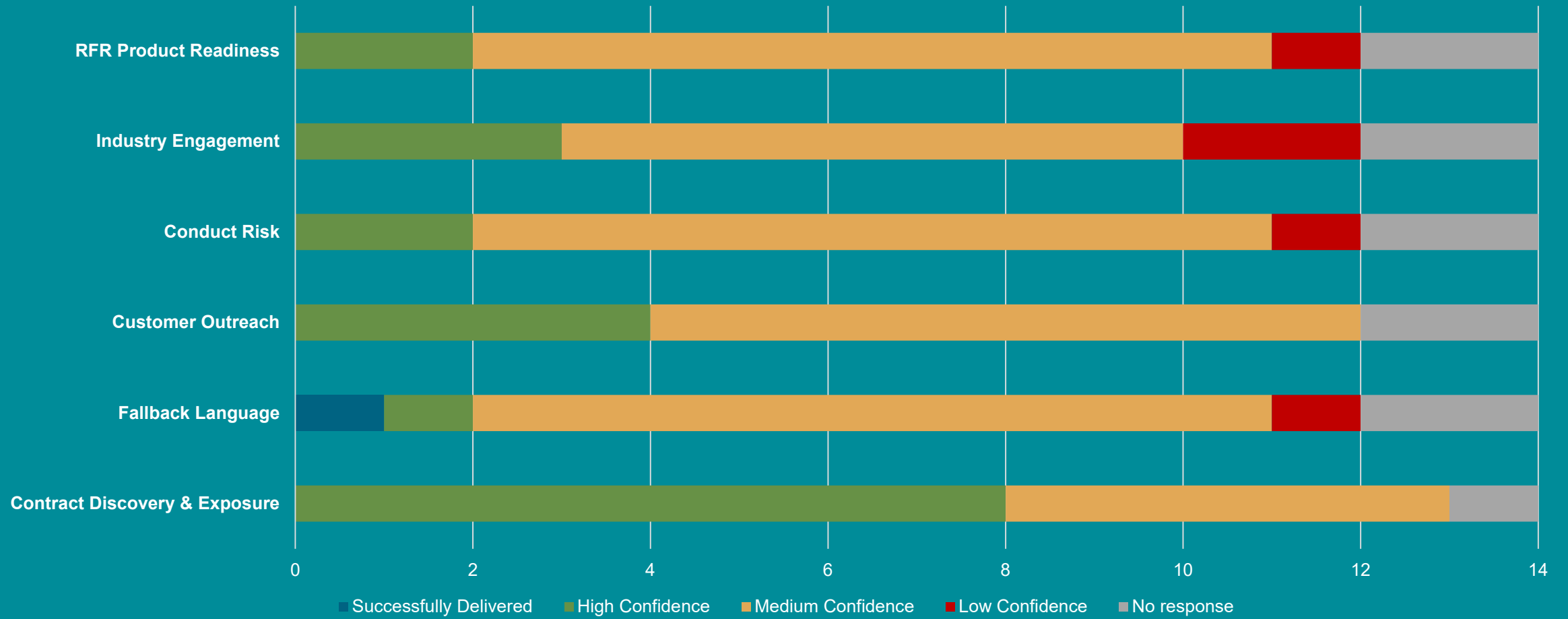
These topics can be translated into **practical steps** for your branch – supporting a **smooth transition** amidst future developments on LIBOR.

We will take a deep dive into each topic, discussing **key challenges** we are hearing, and facilitate working groups in order for you to discuss **best practice** peer to peer.



Survey findings

LIBOR Transition Confidence Survey



Contract discovery & exposure calculations



What are we discussing and why is it important?



Contract discovery - identifying contracts (and products) with direct or indirect LIBOR exposure

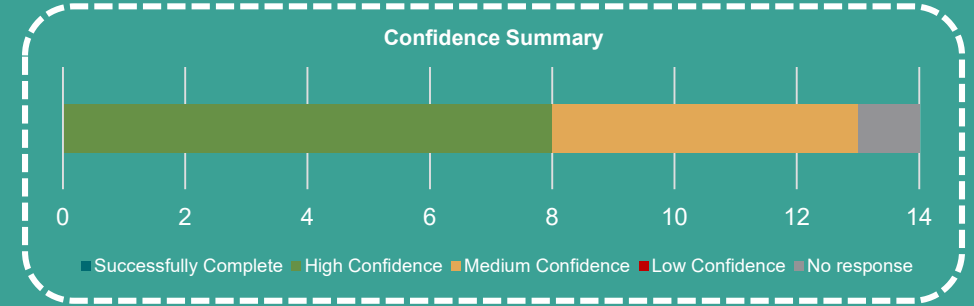
Exposure calculations - calculating LIBOR exposure for in-scope contracts



Why are these topics important?

1. Allows for 'sizing' of LIBOR transition problem
 - Quantum of current and future LIBOR exposure
 - Volume of contracts linked to LIBOR and run beyond 2021
 - Which products need to be re-designed to reference RFRs
2. Allows for transition planning to be undertaken
3. Enables management and regulatory expectations to be met for monitored and reported exposure

What are we hearing?



"My core banking systems don't capture the data I need for loans exposure"

"I was promised AI would make this easy, but we're doing it manually!"

"It's not always easy to identify indirect exposure where it's embedded in clauses etc."

"There are a lot of contracts to work through and they're structured very inconsistently"

Remediating fallback language



What are we discussing and why is it important?

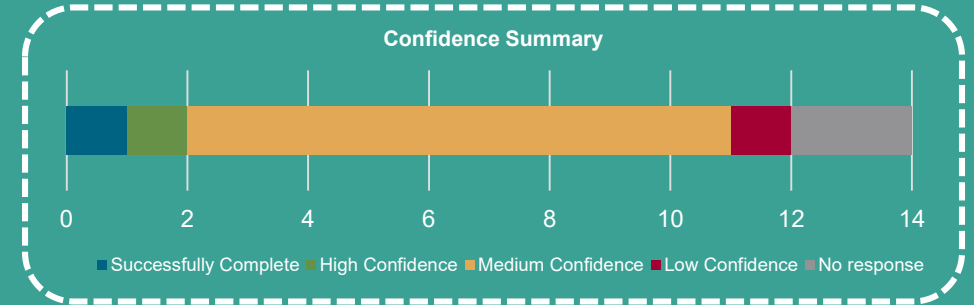


Fallback language refers to contractual provisions that lay out the process through which a replacement rate can be identified if a benchmark is not available i.e. a 'how-to' guide for identifying replacement rates

Why does it need updating?

- Historically, fallback language has not been written to cover the cessation of benchmark rates or the selection of a replacement
- In some instances, existing fallback language requires soliciting quotes from reference or major banks, this approach will become impractical post-LIBOR
- Consequently, obligations for impacted contracts may become impossible or impractical to fulfil without remediation
- Changes to fallback language which impact a customers rates also gives rise to conduct risk if it results in a negative economic outcomes for customers

What are we hearing?



“Our fallback language isn’t captured in systems, we’re needing to go back to contracts”

“There is no ISDA-like protocol for cash products. Each contract needs to be updated on an individual basis”

“We’re not hearing industry consensus on either the type of fallback trigger or the credit spread methodology to use for cash products”

“We don’t know what to do about our ‘tough legacy contracts’ where clients are satisfied with existing fallback language”

Table discussion: Contract discovery, exposure calculation and fallback language remediation



In your groups, we would like you to take 10 minutes to:

1. Identify and rank your top 3 challenges (actual and/or expected), related to:

- Contract discovery
- Exposure calculation
- Remediation of fallback language

2. Discuss practical steps and best practice solutions to each of the challenges

Please use the flip charts to write up your responses and prepare to share with the wider group for discussion

Our recommendations for contract discovery, exposure calculations and fallback language remediation



Contract discovery & exposure calculations

1. Investigate and assess possible methodologies for identifying LIBOR-linked contracts (direct and indirect)
2. Extract relevant data from systems and/or paper contracts
3. Build a central repository of all relevant contracts and calculate exposure
4. Establish a process to maintain and update the database on a periodic basis

Fallback language remediation

1. Identify fallback language in existing contracts and build a digitised library of relevant terms
2. Evaluate relevant terms and determine remediation approach for each (leave as-is, amend, etc)
3. Identify 'tough' legacy contracts that will require additional attention to assist with remediation prioritisation
4. Review LMA exposure drafts related to fallback language and assess possible usage

Consider vendor options for automating the process

Managing conduct risk



What are we discussing and why is it important?



Conduct risk is the risk that a firm's behaviour results in poor outcomes for customers

Why is it important?

It's a key FCA focus area during transition, there is risk of censure, penalties and reputational impact if not managed appropriately.

Banks need to be prepared to demonstrate the reasonable steps they are taking to ensure customers are treated fairly throughout the transition process

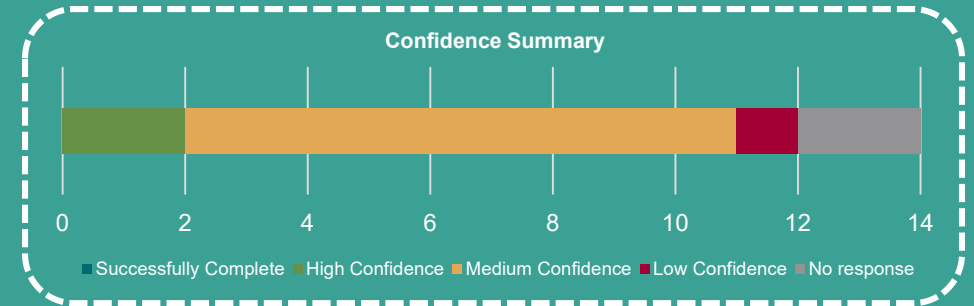
Where will conduct risk arise during the transition?

- When making changes to existing/legacy contracts linked to LIBOR
- Continued activity in LIBOR-linked transactions during the transition
- Undertaking new transactions linked to RFRs

Factors which effect conduct risk exposure:

- Level of client knowledge and understanding about the cessation of LIBOR
- Quality, sufficiency and timeliness of information available to clients to allow them to understand the impacts and make informed decisions
- Ability of the front office to appropriately engage with and educate clients
- Understanding of client segmentation, suitability and customer needs

What are we hearing?



"Different client segments will require different levels of engagement"

"How can I appropriately communicate to clients about RFR based products when market conventions are still forming"

"It is impossible to guarantee that there will be no future value transfer"

"Is holding clients to their contract terms the right thing to do"

Table discussion: Managing conduct risk



In your groups, we would like you to take 10 minutes to discuss:

1. The key conduct risks arising from the transition (maximum 3 risks)
2. The actions to most effectively mitigate them or ensure banks are treating their customers fairly throughout the transition
3. How do the above vary across different client segments?
 - Retail & SME
 - Corporates
 - Financial Institutions
 - Others?

Please use the flip charts to write up your responses and prepare to share with the wider group for discussion

Our recommendations for managing conduct risk during the transition



Conduct Risk

1. Undertake a conduct risk assessment across all stages of the LIBOR transition
2. Review customer segmentation and identify specific needs and impacts of the transition
3. Develop key conduct principles to guide decision making through the transition, including when to discontinue selling LIBOR linked products (and to which clients)
4. Identify and agree new/enhanced LIBOR transition governance, controls and processes to address identified risks and develop a corresponding implementation plan
5. Consider how to measure and evidence the effectiveness of your conduct risk mitigations
6. Document decisions which impact customers

FO awareness & client engagement

1. Develop strategy to increase internal and external awareness of risks and issues regarding the LIBOR transition
2. Start to deliver internal training and awareness courses in line with strategy
3. Start to engage with clients regarding the LIBOR transition as soon as possible

RFR product readiness



What are we discussing and why is it important?



RFR Product Readiness: Development of RFR-linked products and the readiness of processes, models, systems and people to deliver them to market

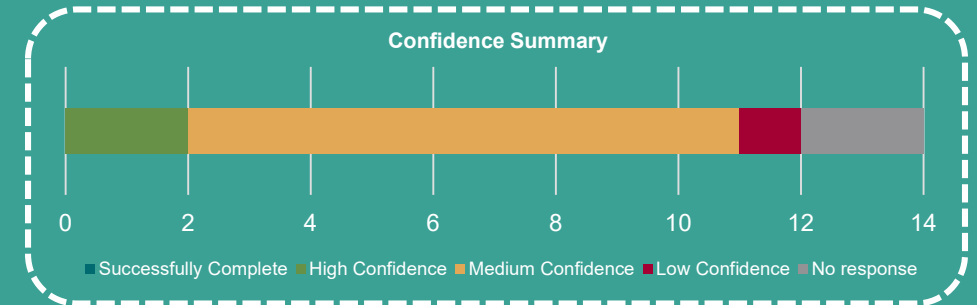
Why is RFR product readiness important?

- Allows for the continued issuance of variable rate products and services to clients
- Avoids regulatory scrutiny and subsequent reputational damage by enabling a transition away from LIBOR

How are RFRs used today?

- RFRs are widely used in derivatives markets and have been for a number of years. They have been primarily used to calculate the floating rate flows for overnight index swaps and floating rate notes
- In all cases so far, the overnight rates have been averaged in arrears using either a simple or compounding methodology
- Regulators have expressed a clear preference for this approach to be adopted for other product types

What are we hearing?



“I’m struggling to find vendor solutions that support RFRs”

“The absence of term structures for RFRs is hindering demand from certain client segments”

“There is no single SONIA compounded screen rate or calculator available for market participants”

“We’ll struggle to have our systems ready in time”

Table discussion: RFR product readiness



In your groups, we would like you to take 10 minutes to:

1. Identify and rank your top 3 challenges (actual and/or expected), related to:
 - Development and market adoption of RFR-linked products
 - Operational uplift required to support RFR-linked products
2. Discuss practical steps and best practice solutions to each of the challenges

Please use the flip charts to write up your responses and prepare to share with the wider group for discussion

Our recommendations for RFR product readiness

RFR Product Readiness

1. Review the Financial Stability Board's user guide for RFRs in cash products
2. Review the preferred industry conventions for RFR-linked products to date
3. Actively engage with industry working groups to understand and influence market direction on product conventions
4. Initiate an assessment of existing operations to determine necessary uplift required to support preferred product conventions to date
5. If possible, run pilot trades with a subset of clients leveraging tactical solutions to test how conventions may perform



Conclusion and wrap up

We have discussed:

- ✓ Why LIBOR is being replaced
- ✓ What the LIBOR transition means for banks
- ✓ What challenges we are hearing across:
 - Contract discovery
 - Exposure calculation
 - Fallback language remediation
 - Managing conduct risk
 - RFR product readiness
- ✓ Practical steps and recommended actions



How BCS Consulting can help

BCS Consulting have **extensive relevant experience and expertise** to support LIBOR transition for your UK branch. We believe in **working collaboratively** with our clients and other providers to deliver change and **achieve outcomes together**



We have 15 years of experience in leading the most complex **regulatory change** programmes across financial services



We have deep capital markets expertise which we are leveraging to help our clients deliver **LIBOR transition**



We have **market leading expertise in conduct risk** established through framework design and multi-year global implementations



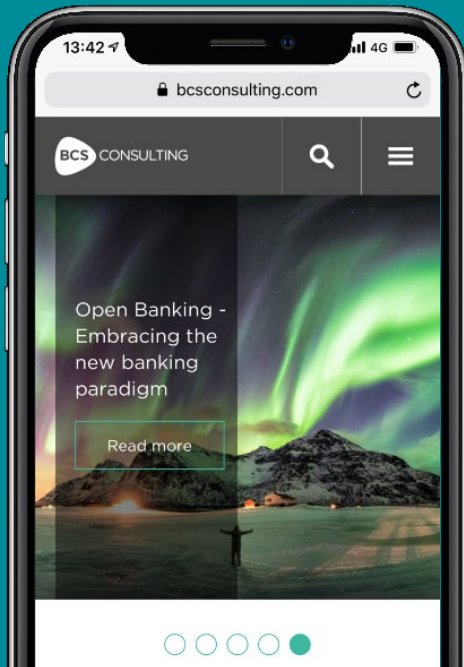
We have a culture of **blending seamlessly with your existing teams**, including where you are operating under a global programme or with other suppliers

Would you like to discuss this further...?

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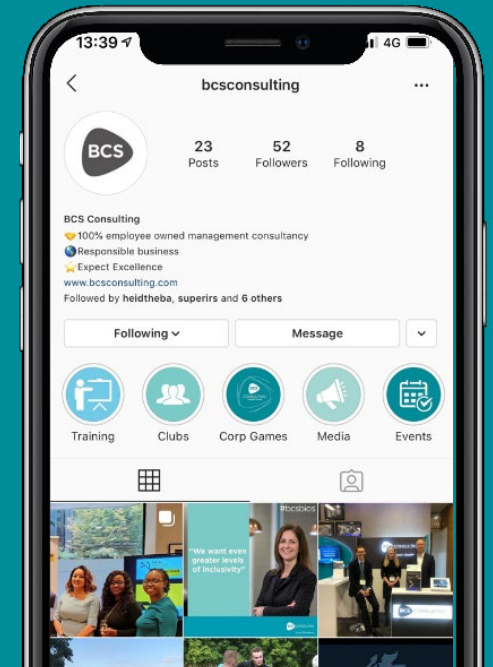
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