THOMSON REUTERS

REGULATORY INTELLIGENCE

FCA's new benchmark powers should push Libor laggards to act; transition conduct a concern

Published 28-May-2021 by
Rachel Wolcott, Regulatory Intelligence

The UK Financial Conduct Authority's (FCA) new benchmark powers should push banks to put more effort into transitioning customers off the London Interbank Offered Rate (Libor) by the year end, consultants said. Libor transition planning and offering quality varies from bank to bank, and consultants have observed new transition-related conduct they fear might disadvantage customers.

"Any additional powers the FCA gets to help cajole banks away from Libor and to move along the process faster, and in a fairer, cheaper way for customers, the better. To be fair, the FCA is one of the bodies who've been keeping their foot on the neck of these bankers, which has even got us to this stage in the transition," said Abhishek Sachdev, chief executive at Vedanta Hedging, a derivatives and corporate finance advisory firm in London.

The FCA is consulting on new powers to support the orderly wind down of critical benchmarks (CP21/15); specifically, Libor. Broadly, the consultation paper sets out how the FCA will stop new use of a critical benchmark once it is clear the benchmark will be ceasing.

Varied approach

UK banks' approach to transition clients off Libor still varies, a mere six months away from the FCA's announced cessation date of December 31. Some are still dragging their heels. Some offer a complex menu of transition options that are difficult for clients to understand. Others are still figuring out how to get clients to transition onto a new rate, Sachdev said.

"Banks have been saying for ages: 'there's no market for this, there's no market for that'. We're bored of this broken record. Banks can innovate and spend money when they want to," he said.

Clients have balked at signing off on transitioning their loans onto a new rate now because it will mean their costs increase.

"If a transition is not agreed on a facilities contract, then at the 31 December the fall backs are going to kick in and none of the fall backs we're seeing is able to cope with using Sterling Overnight Index Average (Sonia) or BoE's Base Rate. Most of them reference the banks' cost of funds which is opaque and even by the banks own admision, "very difficult to calculate". In our experience banks are, as much as they can, moving away from potentially having to use their cost of funds, because they know it's going to be controversial and challenged by their clients," said Paco Carballo, senior consultant at Vedanta.

Banks are taking two to three weeks to explain to clients how a cost of funds fallback rate would be determined, Carballo said. "It's confidential and proprietary and therefore they don't want to disclose it. They are now pushing clients toward other referencing," he said.

"We've seen a UK clearing bank that has actually sweetened their offer for the transition to steer clients from LIBOR to BoE's Base Rate but not to Sonia, by reducing their initial Spread Adjustment if the former is chosen. It would not suprise us that they are trying to push even farther with incentives so that the clients agree on the transition terms as soon as possible. By that I mean getting clients to agree to the terms of the transition now instead of reaching 31st of December with no agreement and having to apply fallbacks that are not robust enough and could be challenged by their clients and a potential rush to amend contracts in the first months of 2022, when clients see how those old fallbacks are triggered," Carballo said.

Zero-per cent floors, no options

One concern is that some banks have introduced 0% floors into their transition arrangements to manage the possibility of negative rates, Carballo said. It is an issue the regulators might not pick up on during the complex process.

"Where I see trouble is in the inclusion by some lenders of 0% floors in their proposed loan amendments due to the LIBOR transition. We've seen some cases in which lenders, regardless of whether the existing loan was hedged or not, they are telling clients because they're going to transition to Sonia or BoE's Base Rate, and potentially those rates could be negative -which was not an expectation a few years ago, when the loan may have been agreed- the amended loan needs to include the floor. And that 0% floor doesn't go hand-to-hand with some compensation from the lender. Precisely because of current market conditions, these floors have a market value and there's a clear value transfer in there, if borrowers do not receive anything in return for that new feature in their loans," Carballo said.

The lack of Sonia option products is another concern.

"We have not seen yet many banks that are ready to offer SONIA or Base Rate option-based hedging products before year end. We fear that potentially many banks may not be able to offer their clients an efficient transition for LIBOR option products that can be 100% effective hedges of SONIA or Base Rate after 31.12.2021. That's important because it's introducing a level of uncertainty for a certain type of hedging instrument that is widely used, ie. caps and floors. If lenders are adding 0% floors on Sonia, but the borrower is unable to neutralise them or trade them out, then that potentially puts borrowers in a difficult position if they will want to hedge their loans with swaps," Carballo said.

Tough legacy contracts

The FCA consultation sets out new powers to enable the regulator to manage limited use of a discontinue rate. In the case of Libor that would be applying boundaries to the use of a to-be-consulted upon "synthetic Libor" rate which the FCA envisions will be used only in a small cohort of tough legacy contracts. The FCA will consider whether and how it could "distinguish with clarity and certainty the classes and characteristics" of [tough legacy] contracts for which it would permit synthetic Libor use.

Once the regulator gets industry feedback on what types of contracts remain to be transitioned, it will be able to decide what comprises a tough legacy contract. It is likely to be a short list comprising mostly trade finance contracts, Carballo said.

The FCA will consult on using these new powers to implement a synthetic Libor rate for some sterling and yen Libor settings, it said.

Complaints Procedure

Produced by Thomson Reuters Accelus Regulatory Intelligence 09-Jun-2021