AFM recommendations regarding conduct risk in the IBOR transition

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The Dutch Authority for the Financial Markets

The AFM is committed to promoting fair and transparent financial markets.

As an independent market conduct authority, we contribute to a sustainable financial system and prosperity in the Netherlands.

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1. Introduction

Interest rate benchmarks based on interbank offered rates (IBORs) are undergoing a period of change as regulators and industry groups have recommended that institutions transition away from IBORs and prepare to replace them with overnight alternative Risk-free Rates (RFRs). This follows from the discovery of manipulation in the submission process for several of these benchmarks in 2011 as well as a decrease in longer-term transactions in underlying markets in the years following the financial crisis of 2008.

RFRs, including SOFR (USD), €STR (EUR) and SONIA (GBP), are overnight reference rates reflecting wholesale funding costs, and are typically administered and published by major central banks worldwide. Transitioning to RFRs is a demanding and complex process for the industry as RFRs are fundamentally different from IBORs due to their differing term structure and inclusion of a broader set of counterparties.

Managing the IBOR transition within a financial institution is thus a complex task which may require significant resources in terms of time, personnel and costs. It affects many different aspects such as the relationship with retail clients and professional counterparties, hedging and pricing of financial instruments, governance and communication. Such a change presents challenges and comes with several risks, among which conduct risk. The latter is deemed important not only by regulators but also by market participants as evidenced in a recent report published jointly by the AFM and DNB – henceforth the AFM/DNB report[1]. This document lays out several aspects of conduct risk and gives recommendations on the behaviour of market participants.

1.1 Requirements for fallback language

Pursuant to the EU Benchmarks Regulation (BMR), existing IBOR-based financial instruments and contracts[2] must be amended to reference alternative rates or provided with a fallback option, and new contracts should include robust fallback options. The need for fallback provisions also applies to EURIBOR- and SARON-based contracts. The AFM/DNB report shows that a large number of contracts, including those referencing EURIBOR, do not yet contain a sufficiently robust fallback option. Moreover, not all newly issued contracts, in particular those referencing EURIBOR, contain appropriate fallback language.

Market participants are primarily responsible for the transition from IBORs to RFRs. The swiftest manner to accomplish this transition is to reference RFRs instead of IBORs in any new financial instrument or contract, and to possibly close out existing positions in instruments referencing IBORs

[1] "The transition to alternative benchmark rates, Feedback report on the interest-rate benchmarks exposures of Dutch financial institutions", 25/11/2020, AFM and DNB. See also: https://www.afm.nl/en/nieuws/2020/november/werk-rentebenchmarktransitie

[2] See article 3 (16),(18) in the BMR

to replace them with instruments referencing an alternative rate. This approach is advised internationally, among others by the International Organization of Securities Commissions.[3]

All contracts currently referencing an IBOR should have appropriate fallback options in place. This follows from article 28 (2) BMR that specifies that users of benchmarks "shall produce and maintain robust written plans setting out the actions that they would take in the event that a benchmark materially changes or ceases to be provided. Where feasible and appropriate, such plans shall nominate one or several alternative benchmarks that could be referenced to substitute the benchmarks no longer provided […]". Hence, market participants that qualify as users as defined in article 3 (7) in the BMR (with the exception of benchmark administrators) are responsible for amending all their contracts referencing IBORs if this requirement is not yet met.

In order to support the transition to RFRs, working groups have been set up, such as the *Working Group on Euro Risk-Free Rates* or the *Working Group on Sterling Risk-Free Reference Rates*. These groups help to develop alternative risk-free rates and give guidance on appropriate fallback language. Market participants should take into account the publications of these groups which also include guidance on hedging and risk management. Moreover, industry associations, such as the *International Swaps and Derivatives Association* (ISDA) and the *Loan Markets Association* (LMA), have developed standard fallback texts and protocols to which market participants can adhere.

1.2 Competencies of national supervisory authorities and EU institutions

Although the IBOR transition primarily requires market participants to take action, some authorities have received specific powers in that respect. The revised BMR provides that the European Commission has the power to determine a replacement rate which would become mandatory by law for the following benchmarks: critical benchmarks, benchmarks with no or few appropriate substitutes, and third country benchmarks whose cessation would significantly disrupt the functioning of financial markets. It should be noted that most IBOR rates fall into one of these categories. Similarly, the Financial Services Act 2021 recently enacted in the UK grants the FCA the power to request the publication of 'synthetic' LIBOR rates not based on contributions of a representative panel of banks in case LIBOR is deemed unrepresentative or ceases to be published by its current administrator.

The adoption of these powers does not exonerate market participants from actively amending their contracts before January 2022, as they are conceived as last resort measures. On the contrary, market participants are encouraged to amend their contracts appropriately now. This will prevent

[3] IOSCO Statement on Communication and Outreach to Inform Relevant Stakeholders Regarding Benchmarks Transition, 31/07/2019 "… the most effective transition from LIBOR linked contracts is to move directly and as soon as possible to RFR linked contracts without having to rely on fallbacks."

the mandatory adoption of a potentially less desirable one-size-fits-all solution that could be imposed by the European Commission in case IBORs cease to be published and the financial stability is deemed in danger due to too few amended contracts.

2. Recommendations for a well-coordinated transition

In order to maintain market liquidity, and to avoid unnecessary market fragmentation and legal and operational costs, market participants, should take heed of standards developed by working groups and industry associations. This is in line with recommendations by the Working Group on Euro Risk-Free Rates.

Fallback options should ideally include the following elements:

- A replacement rate (for instance €STR as a replacement for EONIA)
- A methodology to compute a term structure using overnight rates (the Working Group on Euro Risk-Free Rates has identified and analysed four forward looking term methodologies and eight backward looking term methodologies in different publications)
- A methodology to compute the spread (the Working Group on Euro Risk-Free Rates has identified and analysed four types of spread adjustment methodologies)
- Additional technical provisions (for instance floors on referenced rates)
- The characterization of the trigger event (for instance a cessation or a representativeness trigger)

So-called "hardwired" fallback language, i.e. fallback language that contain all of the elements mentioned above, are highly desirable to reduce risks and enhance transparency particularly for less knowledgeable counterparties or end-clients. Benchmark users may however consider other options. The fallback language should be sufficiently robust, and a simple reference to future market practice is not considered to be appropriate. ESMA has described in more detail when a written plan qualifies as "robust" in its Q&A's on the Benchmark Regulation[4].

Differences in fallbacks may lead to a situation in which existing financial instruments and contracts that reference the same IBOR rate and are otherwise very similar, are amended with differing fallback options, making these instruments less comparable. This may lead to market fragmentation. Possible consequences of increased fragmentation may be the increase in costs for transacting and holding these instruments for financial institutions, which would eventually materialize in higher costs borne by non-professional end clients. Besides facing higher costs, non-professional end clients might also lack understanding of the fallback options chosen and the impact this may have on their financial positions, which may result in misunderstandings and customer dissatisfaction. Other consequences include: (i) worse liquidity of the concerned instruments making transactions costlier, (ii) an increase in the legal complexity faced by institutions when dealing in several of these instruments, and (iii) additional operational issues in particular regarding valuation and hedging.

Steps that market participants can take to foster a harmonized transition are:

[4] Question 8.2 in https://www.esma.europa.eu/sites/default/files/library/esma70-145-114_qas_on_bmr.pdf

- Participating in discussions launched by the Working Groups so that their own views are reflected in final recommendations.
- Adopt fallback clauses that are aligned with recommendations of the Working groups or industry associations
- Adhere to the fallback protocols developed by industry associations

Generally, benchmark users should inform their clients and counterparties about the progress they are making in implementing the transition and on their choices e.g. to follow specific standards. It is particularly important that benchmark users who intend to deviate from solutions proposed by international working groups or by industry associations communicate clearly and in a timely manner their intention to clients or counterparties. They should explain thoroughly the reasons for such deviations as well as potential consequences that their counterparties or clients might face.

Negotiating amendments to existing contracts without following standard fallback clauses leaves the freedom to reach the optimal contractual arrangement for both parties of a contract. However, it also bears the risk that negotiations are misused to other ends, particularly when the bargaining power diverges strongly between both sides involved. One risk is that unfavourable conditions could be imposed upon a counterparty with weaker bargaining power. Another possible issue is that a counterparty could seek to renegotiate parts of the contract that are not directly related to the IBOR reference. These concerns have been expressed both by regulatory authorities and by market participants. Counterparties should prevent such misuse of negotiations and seek to reach a fair solution. Particular attention is required from financial institutions that hold positions in financial instruments or contracts with retail investors. These institutions are responsible for the amendment of the concerned instruments or contracts. This requires from them to take into consideration the interests of their clients, to keep them up-to-date about the transition, and to refrain from any abuse of their more powerful position.

In case a standard solution is preferred, market participants should realize that both counterparties to a contract must adhere to that standard solution for it to become effective. Hence inactivity on one side can prevent the adoption of fallbacks even if the other side has adhered to a standardized supplement or protocol. Market participants are encouraged to engage actively with the counterparties. As mentioned above, the European Commission has the power to impose a default solution in case too few contracts are amended and the stability of the market is threatened, and there is no guarantee that this default solution will be appropriate for all users.

3. Specific recommendations for market participants

3.1 Communication to clients and counterparties

According to the AFM / DNB report, it appears that many financial institutions have not started yet communicating regularly with clients or counterparties holding contracts that will have to be repapered. Some institutions communicate on an occasional basis while others have set up a systematic communication strategy. As already stressed in the report, well-prepared benchmark users should have a communication plan in place and proactively inform their clients or counterparties on their approach of the transition. Tools to provide information comprise the set-up of dedicated webpages, generic or personalized information via letters and emails, as well as regular meetings with clients or counterparties. Moreover, the Working Group on Euro Risk-Free Rates has created a communication toolkit which can help start these conversations.

The information provided to clients or counterparties should be complete and well understandable. The communication tools should be tailored to the client type and the type of instrument or contract concerned. Particular attention should be given to retail clients and small investors who might be less knowledgeable about the transition and its implications. They should be given information that is understandable and tailored to their level of knowledge.

3.2 Internal governance

In order to transition smoothly to RFRs, market participants are advised to make appropriate governance arrangements. They should have a dedicated team in place that monitors the development of the market and of regulation and that implements all necessary steps to identify and amend contracts, update operational systems and communicate on the transition internally as well as externally. Moreover, given the unprecedented and market wide nature of this transition, higher management should be informed regularly of actions taken and challenges faced. It is advisable to establish clear timelines outlining all foreseen actions and to specify these by business segment concerned.

3.3 Contracts

Market participants should evaluate carefully how different types of instruments or contracts are affected by this transition. More specifically, they should identify tough legacy contracts (i.e. existing IBOR referencing contracts that are unable, before the end of 2021, to either convert to a non-IBOR rate or be amended to add fallbacks) and think about solutions together with their counterparties or clients in a timely manner. The risk of neglecting those contracts is that they will be transformed into fixed rate contracts once the referenced IBOR ceases to be published, where the fixed rate is the last published value of the IBOR. This modifies substantially the properties of the instrument and most likely renders it unsuitable for its original purpose. For other contracts a valuation may not be possible at all.

Market participants should also consider whether to tailor fallback provisions to different types of instrument or contract (for instance, optimal solutions may differ depending on whether the product is a widely held and publicly traded financial instrument or whether it is a bilateral contract).

It is important that instruments and contracts are amended in such a way that the economic and legal impact is minimal and as neutral as possible. In particular, when dealing with non-professional clients, market participants should make sure to keep their clients' interests in mind in a manner compliant with their regulatory obligations.

The BMR specifies that it is the responsibility of benchmark users to include fallback clauses in benchmark related instruments and contracts. In case of financial instruments whose terms and conditions have been set by a trading or clearing institution, the latter are considered to be the users of the benchmark. Holders of such instruments, though not formally in charge, should actively support the amendment of their contracts, following closely the steps undertaken by the issuer and seeking contact if necessary, and of course not impede contract amendments.

Last but not least, it is highly recommended to reference RFRs instead of IBORs in all newly issued instruments and contracts. In case newly issued instruments still refer to an IBOR, they should contain fallback language from the date of issuance.

3.4 Operational systems

Moving from IBORs to RFRs requires an adjustment of operational systems to integrate the characteristics of amended contracts as well as the properties of fallback rates. Operational risk is the most important risk indicated by financial institutions in the AFM / DNB report. Market participants should identify its operational systems that are linked to benchmarks and develop a good understanding of how the transition to RFRs (either through a change in rates operationalized while IBORs remain published or by reliance on fallback clauses) impacts their IT requirements. They should update their operational systems accordingly so as to be sure that those systems function properly whenever a switch in the interest rates needs to be realized. It is recommended that operational systems are adequately tested before fallback clauses are activated, for instance by conducting example transactions for a selection of products that are of relevance.

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