LIBOR CONTRACT REVIEW TOOLKIT

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CHAPTER 1:

INTRODUCTION

THE END OF LIBOR

1.1 "**LIBOR**" is the London Interbank Offered Rate. It is the average interest rate at which submitting banks would charge other banks for loans of agreed tenors, and is commonly used as a benchmark interest rate.

1.2 Use of LIBOR is likely to come to an end in 2021 or shortly afterwards. This follows the push from financial services regulators and central banks around the world for a transition away from the use of all interbank offered rates ("**IBORs**") to risk-free rates ("**RFRs**") in accordance with IOSCO and FSB endorsed standards. The push is in part due to the previous attempted market manipulation, false reporting and the decline in liquidity in interbank unsecured funding markets. The regulators driving the transition include the New York Federal Reserve Bank, the Bank of England and the Financial Conduct Authority ("**FCA**").

1.3 The transition from LIBOR to a replacement reference rate presents a challenging regulatory reform for all UK Finance members across a range of products. This Toolkit is aimed at products of providers of residential mortgages and buy-to-let mortgages (including, but not limited to consumer buy-to-let mortgages) ("**Lenders**" or "**you**") who should begin considering (if such process has not already been started) how the transition from LIBOR will affect their mortgage back-books that reference LIBOR. Lenders need to ensure a smooth transition away from LIBOR that takes into account contractual and other legal restraints, as well as the overall aim to ensure customers are treated fairly.

1.4 This toolkit has been prepared to guide Lenders in their review of legacy contracts. However, some of the principles and points for consideration discussed in this toolkit may be equally applicable to new mortgage business you may be considering entering into.

PAVING THE WAY FORWARD

1.5 UK Finance and Pinsent Masons have prepared this Toolkit to assist Lenders with this transition in respect of mortgages with variable interest rates linked to LIBOR. We have prepared this Toolkit following the UK Finance recent survey of Lenders' mortgage terms and some of the issues identified as part of that survey.

1.6 Lenders can use this Toolkit as a starting point for reviewing the terms of their mortgage back-book, and in particular to:

1.6.1 Identify which contracts in the back-book have a LIBOR-linked reference rate.

1.6.2 Assess whether there is a fall-back position built into the definition of LIBOR (or the reference rate) which allows the Lender to introduce a substitute rate when LIBOR comes to an end. The Toolkit will also help Lenders assess the conduct and legal risks in doing so.

1.6.3 Review the variation provisions to assess whether the reference rate can be unilaterally varied, and identify the legal risks in doing so.

1.6.4 Start preparing a LIBOR transition strategy, in light of the risks identified and the context of the business more broadly.

Documenting the decision-making process of transitioning away from LIBOR, and ensuring that corporate governance procedures are followed, will be key in answering any questions you may subsequently get from the regulator about your LIBOR transition strategy.

IMPORTANT THINGS TO NOTE

1.7 **This Toolkit does not contain and should not be regarded as legal advice. It is intended to be used as a guide only. The contract review roadmap should be read in conjunction with the Notes and the disclaimers. This Toolkit is not intended to replace individual or specific legal advice. Lenders should undertake their own analysis and seek legal advice in relation to their particular circumstances.**

1.8 Depending on the terms and conditions of existing mortgages, the legal risk arising in respect of the transition away from LIBOR, may be at a medium to high level (depending on a Lender's particular risk appetite). Lenders are strongly encouraged to carefully assess these risks in the context of their business and overall risk appetite and ensure that they are documented appropriately.

1.9 In preparing this Toolkit we have assumed that LIBOR will be replaced with another RFR, such as a term reference rate linked to the Sterling Overnight Index Average ("**SONIA**"), the Bank of England Base Rate, or an internally set reference rate (such as a Standard Variable Rate). However, that assumption is subject to change and the commentary set out in this Toolkit should be read in light of any replacement rates adopted by the market more broadly or endorsed by regulators.

1.10 **Lenders will need to determine what rate will replace LIBOR in the context of their own business, having regard to applicable laws, relevant regulatory guidance and accepted market practice.**

CHAPTER 2:

LIBOR TRANSITION STRATEGY

INTRODUCTION

2.1 It is important that you prepare a LIBOR transition strategy.

2.2 Your LIBOR transition strategy should set out how you will deal with the risks of substituting LIBOR with a new reference rate. This includes dealing with the legal and conduct risks set out for consideration in this Toolkit, but will include operational and other business risks.

ENSURING FAIR CUSTOMER OUTCOMES

2.3 At the core of your LIBOR transition project is the need to ensure customers are treated fairly. This requirement is at the heart of the FCA's outcomes-based approach to regulation, and the FCA expects all regulated firms to be able to show that fair treatment of customers is embedded in their business model. It is explicitly reflected in PRIN 6 of the FCA's Principles for Businesses (which requires a firm to "*pay due regard to the interests of its customers and treat them fairly*"), and is embedded in the FCA's conduct expectations of firms more broadly.

2.4 Although fair treatment will not necessarily alleviate or solve the legal risks identified with your LIBOR transition, it is likely to inform your risk assessment weightings as well as your risk mitigation strategies.

PREPARING YOUR STRATEGY

2.5 We have set out below some tips to help you develop your internal planning and risk management strategy.

INITIAL CONSIDERATIONS

- Ensure you have engaged legal teams and compliance functions early to ensure the transition risk is understood and appropriately assessed.
- Which governance committees need to be engaged in the process and which ones will provide relevant oversight/sign off?
- When do you need to engage the board of directors to ensure that they are prepared to sign-off on key decisions in the transition process?
- Have you appointed a senior manager with SMCR responsibility to take overall responsibility for the transition and ensure that the board are engaged? In this regard, you may wish to consider the FCA's Dear CEO letter dated 19 September 2018 (available here).
- Have you liaised with the company secretary to ensure that the correct board procedures are complied with?

TIMELINES

- What is your LIBOR transition timeline? What milestones and deadlines do you need to set to ensure delivery of the project by the end of 2021 (or earlier, if appropriate)?
- Have you considered any target timelines or deadlines set by regulatory bodies, such as the Bank of England or the FCA? You should ensure that announcements, speeches and publications from the regulators are carefully monitored and that adjustments to internal timelines are adjusted as appropriate.
- What is the term of the mortgages in the back-book? How will this impact the project timeline?
- How many mortgages are in your back-book? This will be relevant to assessing how long it will take to review the terms and determining the impact this will have on the project timeline.
- When are the board meeting next, and how much notice is needed to add a new item to the board agenda?
- Have you considered which internal systems will need to be updated and the timeframes involved to do so? Have you discussed this with your service provider(s) to ascertain how long it will take them to complete systems updates, and to confirm when they will be available to complete this work?
- Have you factored in the contractual notice periods that you are required to give customers when varying mortgage terms?
- Does your communication strategy allow sufficient time to notify customers of the LIBOR transition? Is this time period fair to the customers? (from paragraph 2.6 below, and see also Note B).
- Will the transition away from LIBOR impact your funding arrangements? If so, how much time is needed to accommodate the transition?

IDENTIFYING STAKEHOLDERS AND INTERNAL RESOURCES

- Have sufficient resources been allocated to support the transition work? You should consider setting up a separate project team to oversee the transition away from LIBOR.
- Have you consulted your accounting team to assess the impact on the mortgage book of replacing LIBOR? Your accounting team will need to consider how your replacement rate performs in comparison to LIBOR, and predict any current or long-term performance issues.
- Have you discussed the transition with your treasury team? In particular, have you assessed any impact on your costs of funding?
- Have you briefed operational teams on the LIBOR transition strategy? You should confirm what system limitations exist and ensure that any implications are clearly understood. Sufficient time should be given to your teams to ensure any operational hurdles can be solved.
- Have you briefed your customer relations and complaints teams on the LIBOR transition and how they should deal with customer queries?
- Can you carry out the initial review internally, or do you need to engage a third party adviser? You should consider whether you would benefit from using technology to audit your mortgage book for LIBOR-linked contracts, or whether it will be more efficient to review the book manually. You will be expected to review all your mortgages to identify LIBOR references, and this may require reviewing several versions of your standard mortgage terms to ensure that you have identified all possible variations.

GENERAL RISK MANAGEMENT

- Have you created/updated the contract risk register to record which contracts will be affected by the transition from LIBOR?
- Have you considered preparing a risk management matrix to evaluate possible LIBOR variations? This could record the proposed approach, the risk weighting, possible outcome/solution and risk mitigation strategies.
- Have you considered preparing a playbook and conducting impact assessments to work through the different scenarios arising out of the LIBOR transition and detail your considerations for the board's review?
- What additional documents might assist the board in their decision making? For example, the following documents may be useful:
    - legal opinions;
    - Q&A documents;
    - draft template agreements;
    - template customer letters and other proposed communications; and
    - relevant regulatory guidance, such as published guidance, Dear CEO letters or speeches from the FCA or another regulatory body, and other background briefing papers such as the papers of IBOR working groups.
- How will you deal with other contractual issues identified as part of the LIBOR transition project, both for existing and new products? You should consider whether you need to redraft any provisions (such as variation provisions, fall-back mechanisms, and definitions) to bring them into line with the FCA's expectations and to address any legal issues identified in this toolkit.

CONDUCT RISK MANAGEMENT: FAIR TREATMENT OF CUSTOMERS

- Have you considered how conduct risks may be identified and managed? In particular, have you considered how you will ensure that:
    - where customers are given advice, the advice is suitable and takes into account their circumstances;
    - customers are provided with products and services that perform or are delivered in accordance with expectations you have set when you sold them the product;
    - you identify and prevent or manage conflicts of interest between yourself and your customers; and
    - you identify and prevent the risk of market abuse.
- Have you developed an effective communication strategy to ensure that you are achieving fair customer outcomes, and that customers are kept informed before, during and after the LIBOR transition and the point of sale of any new product? For further information on this please see from paragraph 2.6.

THIRD PARTY ENGAGEMENT

- Do you have any third party service providers that should be consulted with, or briefed on, your LIBOR transition plan? This is particularly important where third parties are providing any of your key services in relation to the mortgage book, such as may be the case with securitised books.
- Have you engaged with initiatives being led by market participants, trade associations and regulators to ensure that your industry knowledge is up to date? You should ensure that developments are regularly monitored.
- Have you taken into account guidance provided by regulatory bodies and other external materials, such as Dear CEO letters, industry publications, speeches or policy statements?
- Do you need to engage any other third parties, such as an external law firm or a consultant?
- Is it necessary to engage with any regulatory bodies? You should consider whether you need to notify or engage with the FCA on anything you think that they should be aware of in accordance with PRIN 11. Keep under review whether specific points of contact have been nominated by regulatory bodies for LIBOR transition issues and use those if appropriate.

LIBOR COMMUNICATION STRATEGY

PRIN 7 of the FCA Handbook states:
A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.

2.6 Your communication strategy will play a key role in ensuring fair customer outcomes.

2.7 You should ensure that your notices are clear and transparent. This is likely to require including a clear and detailed explanation of the reasons for the LIBOR transition, as well as a worked example of how the replacement rate will affect customers' interest repayments in the short term and over time. You will need to decide whether different explanations will be needed for different products or different customers.

2.8 You will need to decide how much notice you are going to give customers of the LIBOR transition.

2.9 You will also need to decide how you will communicate the LIBOR change. We recommend carrying out a profiling exercise of the affected customers as soon as possible to ensure you have a clear understanding of how the LIBOR transition and any reliance on variation powers is likely to impact affected customers.

2.10 Set out below are some further things to consider when putting together your communication strategy. See also Note B.

NOTICE PERIODS

- How much notice do you have to give of a change under your mortgage terms and conditions?
- Is this the same for all customers, or are there variations across versions or products?
- Are there particular notice requirements under the Mortgages and Home Finance: Conduct of Business Sourcebook ("**MCOB**") that should be complied with.
- Have you taken into account any guidance from the FCA or another regulator about what notice periods are acceptable or unacceptable?
- Is it appropriate to give customers more notice than required under the terms, taking into account your customer profiles? Bearing in mind the need to ensure fair customer outcomes, you should consider how long a customer might need to find a replacement product, should they decide to refinance with another provider as a result of the change. You should also consider whether customers are likely to engage with the notice, particularly if the notice period is quite long.

COMMUNICATING THE TRANSITION

- How will you notify customers of the transition from LIBOR? You should consider whether multiple notification methods are appropriate. We would expect most Lenders to be sending hard copy notices as well as notices by email.
- Is there anything you have learnt from previous communication exercises with customers that would be useful here, for example on the interest-only back book?
- Will you send personalised or tailored notices? You will need to consider whether particular communication strategies will result in more customer engagement.
- Will you send repeat notices? It may be appropriate to send reminders or repeat notices at regular intervals in the lead up to the LIBOR transition. We consider that most Lenders will need to send at least 3 notices of the change. You should also consider whether it is necessary to follow up with some or all customers to ensure the notice has been received.
- How will you deal with returned mail? What other attempts will you make to contact customers if mail does not appear to be getting through?
- Should you include a LIBOR transition statement on your website?
- Are there any regular communications, such as annual statements, that should also include a standard LIBOR transition statement? You will need to consider whether this is possible from an operational perspective.
- What information should you include in the variation notice to ensure it is clear and transparent?
- Do you have any vulnerable customer groups in your mortgage book? Do you need to prepare separate notices to ensure these customers understand the impact of the transition?
- Who can the customer contact if they want more information or to make a complaint or give you feedback? Consider having a dedicated phone number for customers to use.
- Have you prepared scripts for call centre staff to follow when dealing with customer queries relating to the LIBOR transition? You should also consider what other information or training call centre staff will require.

CHAPTER 3:

CONTRACT REVIEW & AMENDMENT

INTRODUCTION

3.1 We have prepared a **contract review roadmap** to assist you to identify the legal risks in replacing LIBOR with a new rate under your existing mortgage terms.

3.2 The roadmap can be used to:

3.2.1 Assess whether there is a fall-back position built into the definition of LIBOR (or the reference rate) which allows you to introduce a substitute rate when LIBOR comes to an end.

3.2.2 Review the variation provisions to assess whether the reference rate can be unilaterally varied, and identify the legal risks in doing so.

3.2.3 Begin to explore other options for substituting LIBOR outside a fall-back or variation provision.

LEGAL CONSIDERATIONS

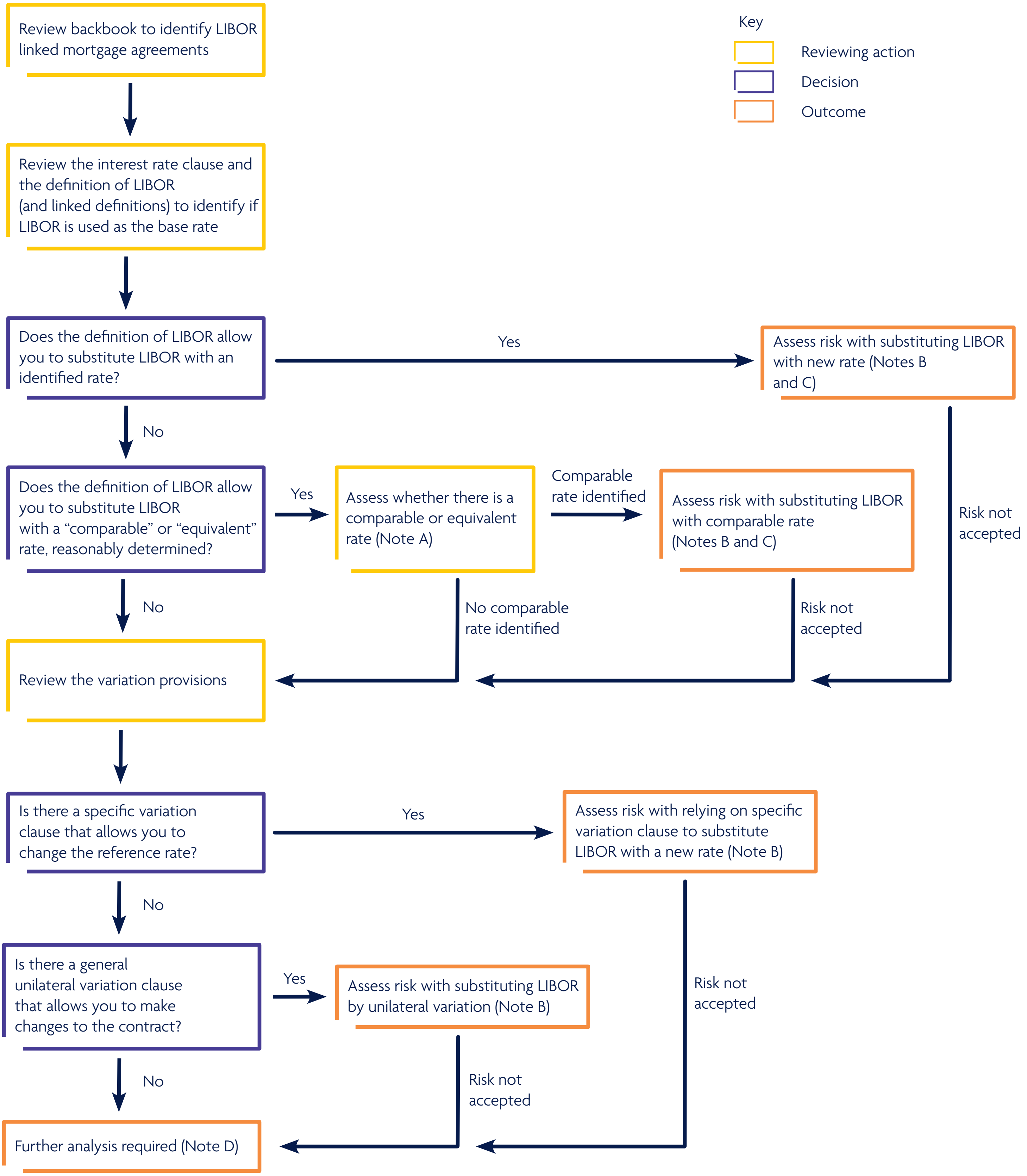
3.3 There are a range of legal issues that should be considered. **It is important to read the roadmap in conjunction with the Notes.**

Some of the legal risks that you will need to consider include:

- Whether the replacement rate is "comparable" or "equivalent" and whether it is reasonable to use the substitute rate, taking into account your mortgage book and how the substitute rate performs in comparison to LIBOR (see further Note A).
- Whether you are exercising a contractual discretion in good faith (see further Note A).
- Whether there is a risk that a clause allowing you to make a variation could be challenged as an unfair term (see further Note B).
- Whether there is a risk that a clause that refers to or is linked to LIBOR is void for uncertainty (see further Note C), or whether the agreement could be considered frustrated (see further Note D).
- Whether variations by agreement could result in a new mortgage contract, and, if so, whether you have the requisite regulatory permissions to enter into the new arrangement (see further Note D).
- What provisions of the FCA Handbook you will need to consider when making the change.
- Whether there is a risk of a complaint being made to the Financial Ombudsman Service ("**FOS**"), a regulator, or a court, and how the risk profiles will vary depending on the claimant's chosen dispute resolution method.

3.4 The list above is indicative only and is not intended to be a complete list of the legal issues and risks that might be identified in your mortgage book. Lenders should consider engaging legal counsel early to ensure risks are identified and assessed.

LIBOR CONTRACT REVIEW ROADMAP



NOTE A:

DETERMINING A "COMPARABLE" RATE

INTRODUCTION

4.1 Your mortgage terms may contain a LIBOR fall-back provision which allows you to replace the LIBOR rate with a "comparable" or "equivalent" rate. The fall-back provision may be contained within the definition of LIBOR, the definition of the reference rate, or in interest rate calculation provisions.

Examples of fall-back provisions

If LIBOR ceases to exist or it is not possible to determine the rate, then the Reference Rate will be another rate as we reasonably determine to be comparable at that time.

"LIBOR" means the London Interbank Offered Rate, which is the average interest rate at which the banks would lend money to each other at on the London market, or, in the event that this rate ceases to exist, the nearest equivalent rate that we reasonably set.

If LIBOR ceases to be made available, we will replace LIBOR with another publicly available rate which we reasonably decide is a comparable rate at that time.

KEY ISSUES

4.2 The key issue will be whether or not there is an alternative rate which is "comparable" to LIBOR. You will need to determine this in the context of your mortgage book, taking into account any emerging market practice and guidance from the regulators.

4.3 You will also need to consider (amongst other things):

4.3.1 Whether there is a risk that the fall-back clause is void for uncertainty because there is a good argument that there is no "comparable" or "equivalent" rate (see Note C).

4.3.2 Whether the clause is at risk of being challenged as an unfair term, because it gives you a broad discretion to unilaterally vary the reference rate (see Note B).

4.3.3 What "LIBOR ceasing to exist" means in practice. You may need to take a risk-based view of what this means in the context of your business, in light of any guidance provided by regulatory bodies, including statements that LIBOR is no longer a representative rate.

REQUIREMENT TO EXERCISE DISCRETION IN GOOD FAITH

4.4. If you are comfortable that the replacement rate is reasonably comparable, you will also need to ensure that the exercise of your discretion to substitute LIBOR is exercised in accordance with principles of good faith. In this context, it will be relevant to consider whether the implementation of the alternative reference rate would significantly disadvantage the customer, both in terms of impact on monthly repayments and the transition strategy itself.

GUIDANCE ON DETERMINING A "COMPARABLE" RATE

4.5 A number of firms and industry groups are working towards deciding what will replace LIBOR across various markets. Replacement rates have been put forward, such as SONIA, and various groups are determining what credit spreads can be applied to its various iterations to come to a consensus as to equivalence to LIBOR. It is important that you monitor these industry developments, as it is anticipated that an industry consensus will emerge as to what rate should replace LIBOR in a range of contracts including mortgage contracts. You should also ensure you monitor commentary from regulatory bodies on the work of these groups.

4.6 Set out below are some considerations and practical steps that may assist you in assessing whether a proposed replacement rate is reasonably comparable or equivalent for the purpose of relying on these fall-back provisions, and whether it will result in mortgages performing as customers expected them to, therefore resulting in a good outcome for your customers.

ASSESSING A NEW REFERENCE RATE

- What guidance has been published by regulators or industry groups, and does this indicate whether certain RFRs are comparable rates? Can the guidance be applied to your mortgage book?
- Has an established market practice for the replacement of LIBOR been developed, and if so, is your substitution of LIBOR consistent with this?
- What will monthly repayments look like for the customer using the alternative rate? **If the replacement rate results in a significant increase in the customer's monthly repayments, this is unlikely to be consistent with ensuring a fair customer outcome and contrary to PRIN 6**. When assessing this, you may wish to consider the following:
  - How do the interest rate calculations for the alternative rate compare to the LIBOR rate calculations within the contract?
  - Does the substitute rate work under your contract terms? For example, does it work with your existing reset provisions?
  - How does the underlying data for the alternative rate compare with LIBOR, both in quantum and volatility, and are there any significant differences or scope for change in the future?
  - Is the replacement rate supported by your systems?

PRACTICAL STEPS

- Can you vary the mortgage terms to accommodate the new reference rate to ensure it works in a "comparable" way? For example, is it appropriate to change the margin, or the reset provisions? You will need to rely on existing variation provisions to do this, and you should also consider whether the way in which you make changes could result in a new mortgage contract being entered into (see further Note D).
- Can you continue to use LIBOR as at the last reset date, and remove or waive reliance on reset provisions? Whether this is appropriate will depend on the size of your affected book, how industry-accepted rates operate and how your mortgage book is funded.
- What will you do if the substitute rate is not performing as you expected? Can you include a review mechanism or a fall-back provision in the terms to ensure unforeseen consequences can be addressed?
- What other processes can you put in place to ensure you continue to review and monitor the performance of the substitute rate, as compared to LIBOR? How will this be reviewed in governance?
- **Have you documented your decision making process? You should make sure you record all factors you considered, including potential challenges and how they have been addressed.**

WHERE THERE IS NO "COMPARABLE" RATE

4.8 If there is no "comparable" rate that can be reasonably determined, you may not be able to rely on these types of fall-back provisions and you will need to look to other variation powers in the mortgage terms.

4.9 You may also need to rely on broader variation rights if the fall-back provision:

4.9.1 Allows for a change to the LIBOR rate on a temporary, rather than a permanent, basis.

4.9.2 Allows the reference rate to be substituted with another rate provided by a reference bank, where there is no such rate being provided.

NOTE B:

UNFAIR CONTRACT TERMS

INTRODUCTION

5.1 A key legal issue for most Lenders when determining whether to exercise a unilateral variation power will be whether the variation provision is at risk of being challenged by a customer as an unfair term.

5.2 Under the Consumer Rights Act 2015 ("**CRA**"), an unfair term in a consumer contract is not binding on the customer (although he or she can choose to rely on the term). This may have difficult consequences in the context of the LIBOR transition and Lenders will need to carefully consider their position.

5.3 Pursuant to Section 62(4) of the CRA, the test for determining if a term is unfair is:

> *if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations under the contract to the detriment of the consumer.*

5.4 The unfair terms rules apply to most consumer contracts entered into on or after 1 October 2015. A "consumer contract" is a contract between a trader and a consumer. "Consumer" is defined to capture individuals acting for personal purposes (i.e. outside his or her usual trade, business or profession). As this is a wide definition, most retail mortgages will be caught by the unfair terms regime. For mortgages entered into before 1 October 2015, Lenders will need to consider whether the Unfair Terms in Consumer Contracts Regulations 1999 apply to each mortgage.

5.5 The unfair terms regime under the CRA does not apply where the customer has a business purpose. As such, it won't apply to buy-to-let mortgage contracts that are not "consumer buy-to-let mortgage contracts" within the meaning of The Mortgage Credit Directive Order 2015. However, Lenders of buy-to-let mortgages may wish to take unfair terms considerations into account when considering their LIBOR transition plans and fair treatment of customers more generally.

GUIDANCE ON THE FAIRNESS OF VARIATION TERMS

5.6 Whether a term is unfair under the CRA can only be determined by a court. Generally speaking, Lenders must therefore assess whether their terms meet the requirements of the CRA, in light of relevant case law.

5.7 The FCA also has a range of powers in relation to unfair contract terms, which are set out in the "Unfair Contract Terms Regulatory Guide" in the FCA Handbook.

5.8 In December 2018, the FCA published its Finalised Guidance "FG18/7: Fairness of variation terms in financial services consumer contracts under the Consumer Rights Act 2015" ("**Finalised Guidance**") (available here). Although the Finalised Guidance is not binding on Lenders, it does contain a useful starting point for assessing where a term could be challenged by a customer as unfair.

5.9 The Finalised Guidance contains a non-exhaustive list of factors which the FCA considers to be "relevant to determining whether or not a variation term is fair" under the CRA. These factors have a common theme of "transparency", which is both a separate consideration under the CRA as well as a factor relevant to assessing fairness. This reflects recent developments in case law in the UK and in the European Union, and Lenders should consider the relevance of those cases when assessing fairness.

5.10 You should also consider other regulatory guidance that may be relevant to your mortgage contracts. For example, the theme of transparency, as well as other factors the FCA considers relevant to assessing fairness, are also reflected in recent guidance on unfair terms published by the European Commission (available here). The Competition and Markets Authority has also issued guidance on unfair contracts terms (available here).

5.11 **You should carefully assess the legal risk of relying on your variation provisions in light of relevant case law, as well as regulatory guidance (including the Finalised Guidance) and any other factors that are relevant in the circumstances.**

UNFAIR TERM VS. A FAIR OUTCOME

5.12 Generally speaking, treating customers fairly when making a change to a contract will not, as the FCA summarises, “change an unfair variation term into a fair one”. This is because the time for assessing fairness is at the beginning of the contract, not the point you are making the change. This is an important distinction to keep in mind when approaching LIBOR substitution.

5.13 From a legal point of view, you will need to assess each variation term in light of the contract as a whole, and not in relation to the change proposed. This means there may be a high risk in using a variation term if it does not meet the above criteria, even if the particular change being made benefits customers. Fair outcomes are of course relevant to assessing notice periods and demonstrating a fair balance of rights and obligations, particularly in longer-term contracts such as mortgages and in relation to the LIBOR transition. However, the risk here is that the general variation provision is successfully challenged by a customer in court, rendering it void for the remainder of the loan.

5.14 You will need to carefully consider how you can mitigate this risk through communication strategies and notice periods.

FAIRNESS OF SPECIFIC VARIATION POWERS

5.15 There is generally a relatively low risk that a term that specifically allows a variation of the reference rate would be found to be void as an unfair term.

5.16 Broadly speaking, we expect that you will be able to establish that you and your customers each have a legitimate interest in varying the contract to accommodate the transition away from LIBOR. The risk of a term being held void as an unfair term will be relatively low if the reasons for varying the contract are closely tied to the clause itself.

5.17 This may be the case, for example, where a variation clause allows you to vary the reference rate specifically to accommodate a change in regulatory practice.

5.18 This risk will need to be considered in the context of your particular mortgage book. There may be instances where there is a higher risk of unfairness in these sorts of clauses, such as where the variation clause does not limit your discretion by reference to reasonableness, or where you are not obliged to give notice of the change.

FAIRNESS OF GENERAL VARIATION POWERS

5.19 Where contracts do not have specific reference rate variation provisions, you may need to rely on a general unilateral variation clause to replace LIBOR.

5.20 Unilateral variation clauses come in many forms – some give Lenders general rights to vary the contract for any reason, whereas others are limited to changes required to reflect changes in law or regulation (for example). Each clause will need to be assessed against its terms.

5.21 If you are seeking to rely on a broad variation clause to replace LIBOR, there is likely to be a higher risk that the term could be challenged by a customer as unfair. Generally speaking, where the clause does not articulate the reasons that a change can be made, the clause may not be transparent. This risk is exacerbated by the fact that customers may have limited freedom to exit, as it may be too difficult for them to find an alternative to the mortgage contract. Ensuring a fair outcome for customers (being one that does not result in the customer paying a higher monthly repayment) will be key to mitigating a risk of challenge in respect of these variation provisions.

ASSESSING FAIRNESS

ASSESSING UNFAIR TERMS RISKS

- Is your unilateral variation clause specific or general?
- Does your variation clause meet the criteria set out in the Finalised Guidance, in light of the FCA's commentary on each criterion?
- Have you included the variation term "to achieve a legitimate objective"?
- Are the reasons for amending the contract "no wider than is reasonably necessary to achieve a legitimate objective?"
- Are the reasons for variation under the contract objective and clearly expressed, and is it is possible to verify that the reasons have arisen? This goes to assessing the terms of the contract itself, and not simply the reason you need to vary the contract.
- Is your contract (and ancillary documents) written in such a way so that your customers understand the consequences of a future variation? This should be assessed at the time the contract was concluded.
- What, if any, notice of the variation does the contract require you to give the customer?
- Will the customer have "freedom to exit"? This will require looking at the contractual provisions (for example, exit notice provisions and exit fees), and also considering what practical barriers to exit might exist. You might want to consider waiving any exit fees, for example, which might be seen as a barrier to exit.
- Does the term strike a fair balance between your legitimate interests and the legitimate interests of your customers?

MITIGATING STEPS

- **Are you using your variation provision to achieve a fair outcome?** That is, have you ensured that customers are not paying a higher monthly repayment after you replace LIBOR? This will be key in mitigating unfair terms risk.
- Can you vary the variation terms now so that the terms specifically allow you to change the reference rate when LIBOR is discontinued? You will need to rely on your existing variation provisions to do this, so you will need to carefully assess the risk of challenge to this “tiered” approach.
- What changes should you make to your terms and conditions going forward to align your variation provisions to the requirements of the CRA and the FCA’s expectations? You should consider removing vague or unclear language with a view to enhancing the certainty of the provisions in your terms and conditions.
- Are there any other legal issues with your variation provisions? For example, broad variation powers may be at risk of being challenged as void for uncertainty. Courts have found that where a broadly drafted clause is vague or ambiguous in its application, the clause is void for uncertainty and therefore unenforceable.
- You should consider engaging legal counsel to ensure that your variation provisions are enforceable and can be relied on, particularly if your rate needs to be replaced. We note that these considerations may also be relevant when drafting the terms and conditions for new mortgage contracts.

NOTE C:

UNCERTAINTY OF CONTRACT

6.1 You may need to consider whether, by reason of LIBOR being discontinued, clauses that reference or are linked to LIBOR are at risk of being challenged as void for uncertainty.

6.2 When LIBOR ceases to exist or becomes unrepresentative, terms that reference LIBOR (including interest rate provisions, fall-back clauses and references to interest rate calculations) may cease to have a definite meaning. The basic principle is that a court will not enforce a contract which cannot be given meaning.

6.3 Finding that a term is void for uncertainty is generally used as a "last resort" where a clause is so vague or lacking in meaning that the court cannot give it meaning. Where a party makes a claim of uncertainty, courts will generally aim to give practical meaning to the parties' obligations in light of their intent, either by interpreting the clause in a different way (in line with statutory or common law interpretation rules, including those under the CRA) or by implying a new term.

6.4 Whether a Court will be able to give the LIBOR-linked clause meaning or imply a term is likely to depend on any emerging market practice relating to the substitution of LIBOR, as well as the particular terms being reviewed and the customer's circumstances. You will therefore need to consider these types of arguments in the context of your mortgage book.

ASSESSING UNCERTAINTY

- How would a court interpret your LIBOR-linked clauses, in light of Section 69(1) of the CRA and the contra-proferentem rule?
- What is the risk that a court (or the FOS) would find a LIBOR-linked clause void for uncertainty and therefore unenforceable? What are the consequences of this happening?
- Can you vary your LIBOR-linked provisions to ensure they can be given meaning after LIBOR is discontinued? You will need to rely on your existing variation provisions to do this, so you will need to carefully assess the risk of challenge to this approach.

NOTE D:

VARIATION BY AGREEMENT

7.1 Where your mortgage terms and conditions do not contain a fall-back clause or a unilateral variation power that you can rely on, you will need to consider whether LIBOR can be substituted with the customer's agreement. This could be done by side letter or variation deed, but in either case the customer's consent will be required. Whether this is practical is likely to depend on the size of your affected mortgage book and the profile of customers in the book.

7.2 Before agreeing a replacement rate with customers, you will need to consider whether, as a matter of contract, the replacement of the reference rate is so fundamental to the mortgage that the variation amounts to entering into a new mortgage contract. This is likely to depend on what the new reference rate is, and the extent to which the customer's repayment obligations are substantially altered.

7.3 Where the variation agreement does have the effect of creating a new mortgage contract, you will then need to consider the regulatory impact of this and ensure you comply with applicable laws and rules.

7.4 It is possible that some customers will not expressly agree to substitute a new rate for LIBOR. Where this happens, you will need to consider how to proceed. In this context, it may be relevant to consider any termination rights under the mortgage, or whether the contract could be discharged by frustration. PRIN 6 of the FCA's Principles for Businesses (which requires a firm to "*pay due regard to the interests of its customers and treat them fairly*") will still apply in this context.

VARIATION BY AGREEMENT

- Is it practical to agree with customers a replacement rate?
- What is the most appropriate way for you to agree a replacement rate, taking into account your customer base and operational considerations?
- How much notice will you give customers, and how will you communicate with them?
- What is the legal risk that entering into the variation would result in a new contract? Have you considered the regulatory implications of this?
- Do you have a strategy for those customers that may not respond to or agree to such a variation?