IBOR Fallbacks: Overview

This webinar is intended to assist market participants in understanding the new 2020 Consultation on How to Implement Pre-Cessation Fallbacks in Derivatives. In particular, this webinar will provide market participants with:

- an update on ISDA’s work and progress;
- an explanation of how the risk-free rate fallbacks are adjusted;
- an overview of the consultation;
- an explanation of the question posed by the consultation;
- an illustration of the approach if the consultation criteria are met;
- an illustration of the approach if the consultation criteria are not met; and
- an indicative timetable.
IBOR Fallbacks: ISDA’s Work – Fallbacks and Permanent Cessation Trigger

• ISDA is currently undertaking work to amend the 2006 ISDA Definitions to implement fallbacks for: LIBOR in GBP/CHF/USD/EUR/JPY, EURIBOR, JPY TIBOR, Euroyen TIBOR, BBSW, CDOR, HIBOR and SOR (the IBORs).

• The fallbacks are currently drafted so as to apply upon the permanent discontinuation of the relevant IBOR (based on pre-determined, objective triggers) and will be to the relevant alternative risk-free rate (RFR), subject to term and spread adjustments. The permanent discontinuation trigger is defined as “Index Cessation Event”.*

• “Index Cessation Event” means:
  
  – a public statement or publication of information by or on behalf of the administrator of [the relevant IBOR] announcing that it has ceased or will cease to provide [the relevant IBOR] permanently or indefinitely, provided that, at the time of the statement or publication, there is no successor administrator that will continue to provide [the relevant IBOR]; or
  
  – a public statement or publication of information by the regulatory supervisor for the administrator of [the relevant IBOR], the central bank for the currency of [the relevant IBOR], an insolvency official with jurisdiction over the administrator for [the relevant IBOR], a resolution authority with jurisdiction over the administrator for the [the relevant IBOR] or a court or an entity with similar insolvency or resolution authority over the administrator for [the relevant IBOR], which states that the administrator of [the relevant IBOR] has ceased or will cease to provide [the relevant IBOR] permanently or indefinitely, provided that, at the time of the statement or publication, there is no successor administrator that will continue to provide [the relevant IBOR].

* The fallbacks will not apply until the actual discontinuation of the relevant IBOR (if that is after the announcement date).
IBOR Fallbacks: ISDA’s Work – Implementation of Fallbacks in Supplement

Form of Amendments

• **Supplement to the 2006 ISDA Definitions**: To account for any permanent discontinuation of a relevant IBOR, amendments to the floating rate options in Section 7.1 of the 2006 ISDA Definitions for the relevant IBORs will take the form of:

  – a statement identifying the objective triggers that would activate the selected fallbacks (see ‘Index Cessation Event’ on the previous slide); and

  – a description of the fallbacks that would apply upon the occurrence of that trigger, which will be:

    i. the relevant RFR adjusted using methodologies to account for (A) the fact that the RFR is an overnight rate and (B) the various premia included within the IBOR; and

    ii. if the relevant RFR is permanently discontinued, one or more further fallbacks.

Upon publication of the Supplement, all **new** derivative transactions entered into on or after the date of the amendments that incorporate the 2006 ISDA Definitions will include the fallbacks (counterparties will **not** have to take any additional steps).
Examples of permanent cessation fallbacks from the current draft Supplement to the 2006 ISDA Definitions:

**GBP LIBOR**

> Permanent Cessation:

Following the occurrence of an Index Cessation Event and from the Index Cessation Effective Date:

1. References to GBP LIBOR to be read as references to adjusted SONIA plus a spread.
2. If adjusted SONIA is permanently discontinued, references to adjusted SONIA to be read as references to the bank rate set by the Monetary Policy Committee of the Bank of England plus a spread (this spread will be the same spread as used for adjusted SONIA after making any necessary adjustments).

**USD LIBOR**

> Permanent Cessation:

Following the occurrence of an Index Cessation Event and from the Index Cessation Effective Date:

1. References to USD LIBOR to be read as references to adjusted SOFR plus a spread.
2. If Adjusted SOFR is permanently discontinued:
   a) Fed Recommended Rate*
   b) Daily Overnight Bank Funding Rate*
   c) Short-term interest rate target set by the Federal Open Market Committee*

* plus a spread (this spread will be the same spread as used for adjusted SOFR after making any necessary adjustments)
IBOR Fallbacks: ISDA’s Work – Implementation of Fallbacks in Protocol

Form of Amendments

• **ISDA 2020 IBOR Fallbacks Protocol**: ISDA will also publish a protocol to facilitate inclusion of the amended floating rate options (i.e., the definitions with fallbacks) into *existing* derivative contracts entered into prior to publication of the Supplement.

  – Adherents to the Protocol will agree that derivative transactions that they have entered into *with other adherents* prior to publication of the Supplement will be based on the relevant amended floating rate options in the 2006 ISDA Definitions, notwithstanding when the transactions were entered into.

  – The Protocol will cover those ISDA master agreements, ISDA credit support documents and confirmations that:

    i. incorporate one of several ISDA definitional booklets;

    ii. reference an IBOR as defined in or has the meaning in one of several ISDA definitional booklets; or

    iii. reference an IBOR howsoever defined.

  – The Protocol will also extend to additional non-ISDA master agreements and credit support documents. These documents are under discussion in the ISDA working groups and are subject to confirmation.
IBOR Fallbacks: Adjustments to Fallback Rates

Form of Adjustments

• The RFRs are adjusted (1) to reflect the fact that the IBOR is a term rate and (2) to factor in the embedded bank credit spread element of the IBOR.

• The current methodology is:

  – RFRs are based on the **compounded setting in arrears rate** and the **five year historical median approach to the spread adjustment**.

  – The **compounded setting in arrears rate** is the RFR observed over a period (generally equivalent to the relevant IBOR tenor) and compounded daily. The rate is adjusted whereby the observation period is backward-shifted to allow for the rate to be known prior to the relevant payment date.

  – The **five-year historical median approach to the spread adjustment** is based on the median spot spread between the IBOR and the term-adjusted RFR calculated over a static lookback period of five years prior to the Index Cessation Event. The spread adjustment will be added to the compounded setting in arrears rate (but will not be compounded itself).
IBOR Fallbacks: Adjustments to Fallback Rates (cont.)

Form of Adjustments

1: 1 BD prior to Index Cessation Event
2: Index Cessation Event, i.e. announcement that index will permanently cease to be available
3: Index Cessation Effective Date, i.e. index actually permanently ceases to be available

2020 Consultation on How to Implement Pre-Cessation Fallbacks in Derivatives
IBOR Fallbacks: Consultation on How to Implement Pre-cessation Fallbacks

- On February 25, 2020, ISDA launched a market consultation on how to implement pre-cessation fallback provisions for LIBOR in the Supplement to the 2006 ISDA Definitions and the related ISDA 2020 IBOR Fallbacks Protocol. This consultation follows on from ISDA’s 2019 consultation on pre-cessation issues for LIBOR derivatives and is launched on the basis of additional information now in the market.

- The consultation is available at https://www.isda.org/2020/02/24/2020-pre-cessation-fallback-consultation/. This link also contains information about how to submit responses.

- The consultation will remain open until March 25, 2020.

- During the consultation period, please submit questions to FallbackConsult@isda.org.

- ISDA will analyze the responses to this consultation and determine the approach for implementing pre-cessation fallback provisions for LIBOR in the Supplement to the 2006 ISDA Definitions and the ISDA 2020 IBOR Fallbacks Protocol.

- ISDA will publish a full explanation of how it made the determination based on the data gathered.

2020 Consultation on How to Implement Pre-Cessation Fallbacks in Derivatives
IBOR Fallbacks: Consultation Question

• The consultation requests a response to a ‘Yes/No’ question:
  – While the current version of the Supplement to the 2006 ISDA Definitions contains fallbacks that would apply upon a permanent cessation of LIBOR*, should it also contain a pre-cessation trigger, such that the fallbacks apply upon the first to occur of (i) a permanent cessation trigger or (ii) a ‘non-representativeness’ pre-cessation trigger, with the combined permanent cessation and pre-cessation fallback provisions also reflected in the ISDA 2020 IBOR Fallbacks Protocol?

• Note that in this scenario, if ‘non-representativeness’ occurs prior to ‘permanent cessation’, then the spread adjustment calculated as of the relevant announcement date regarding ‘non-representativeness’ would be the only spread applicable under the 2006 ISDA Definitions.

• Respondents are requested to indicate whether, if they select “No”, they would be unavoidably harmed by, and/or unable to use, a Supplement and Protocol that implement pre-cessation fallback provisions in the manner described in the question.

* Note that the consultation relates only to LIBOR and not any relevant IBOR.
IBOR Fallbacks: Consultation Criteria

• The approach set out in the consultation question will be implemented if the following criteria are satisfied:
  
  – At least 70 market participants (which do not include professional services firms or trade associations) submit responses. Any responses that do not clearly indicate “Yes” or “No” will not be counted in this number. Affiliated entities will be counted as one market participant for purposes of this count and for calculating the percentages below.
  
  – At least 35% of responses are from market participants other than bank/broker-dealers and infrastructure providers.
  
  – At least 65% of respondents select “Yes” and at least 35% of those who select “Yes” are not bank/broker-dealers or infrastructure providers.
  
  – Respondents who select “No” and indicate that they would be unavoidably harmed by, and/or unable to use, such a Supplement and Protocol do not represent a significant portion of a particular segment of the market (e.g., all insurance companies who respond, all corporates who respond).
IBOR Fallbacks: Changes to Documentation if Consultation Criteria Met

• If the consultation criteria are satisfied, several amendments will be made to the draft Supplement to the 2006 ISDA Definitions, including:
  
  – the definition of “Index Cessation Event” for LIBOR will be amended to include a pre-cessation trigger alongside the permanent cessation trigger which is currently included. Suggested drafting for the amended definition is as follows, although this draft language is subject to further review and discussion:

    [“a public statement or publication of information by the regulatory supervisor for the administrator of [LIBOR in the relevant currency] announcing [(a)] that [LIBOR in the relevant currency] is no longer, or as of a specified future date will no longer be, capable of being representative, or is non-representative, of the underlying market and economic reality that [LIBOR in the relevant currency] is intended to measure as required by applicable law or regulation and as determined by the regulatory supervisor in accordance with applicable law or regulation [and (b) that the intention of that statement or publication is to constitute a trigger for fallbacks in derivative contracts].”]

    - the definition of “Index Cessation Effective Date” for LIBOR will be amended to address the existence of the pre-cessation trigger. The Index Cessation Effective Date for the pre-cessation trigger will be the date on which LIBOR in the relevant currency ‘is no longer representative’, which may either coincide with or be after the date of the announcement that it is ‘no longer capable of being representative’.

2020 Consultation on How to Implement Pre-Cessation Fallbacks in Derivatives
• An example of a rate option in the current draft **Supplement to the 2006 ISDA Definitions:**

  **Rate Option: USD-LIBOR-BBA** (*as currently drafted*)
  
  This will be equivalent to USD-LIBOR-BBA but will include (i) provisions dealing with temporary cessation, (ii) an Index Cessation Event trigger and (iii) a fallback to compounded SOFR plus spread* following an Index Cessation Event.
  
  * The spread will be calculated on the business day before the public statement/information constituting an Index Cessation Event by reference to historical data at that time (the “permanent cessation spread”).

• An example of the same rate option in the **Supplement to the 2006 ISDA Definitions** as amended if the consultation criteria are satisfied:

  **Amended Rate Option: USD-LIBOR-BBA** (*amended rate option*)
  
  This will be the same as Rate Option 1 but will also include a pre-cessation trigger and a fallback to compounded SOFR plus spread* following that pre-cessation trigger.
  
  * If a pre-cessation trigger event occurs, the spread will be calculated on the business day before the announcement by the regulator that USD LIBOR is not representative by reference to historical data at that time (the “pre-cessation spread”).
  * If a permanent cessation announcement subsequently occurs, the spread applicable to fallbacks under the 2006 ISDA Definitions will remain the same and will not be subsequently adjusted to account for the permanent cessation.
  * If a permanent cessation announcement occurs prior to the pre-cessation announcement, the spread will be calculated on the business day before the permanent cessation announcement by reference to historical data at that time (i.e. a “permanent cessation spread” will be used).
  * If a pre-cessation announcement and permanent cessation announcement occur at the same time, compounded SOFR plus spread will apply from the earlier to occur of the effective date of the pre-cessation trigger event and the effective date of the permanent cessation trigger event.
IBOR Fallbacks: Changes to Documentation if Consultation Criteria Met (cont.)

- If the consultation criteria are satisfied, equivalent amendments will also be made to the draft ISDA 2020 IBOR Fallbacks Protocol.
- See below for an illustration of both the pre-cessation trigger and then, subsequently, the permanent cessation trigger occurring pursuant to the combined “Index Cessation Event” definition.

1: 1 BD prior to Pre-cessation Index Cessation Event
2: Pre-cessation Index Cessation Event, i.e. announcement that index is no longer capable of being representative (and therefore will no longer be representative as of 3 (which may either coincide with 2 or be after 2))
3: Pre-Cessation Index Cessation Effective Date, i.e. index actually is no longer representative
4: Permanent Cessation Index Cessation Event, i.e. announcement that index will permanently cease to be available
5: Permanent Cessation Index Cessation Effective Date, i.e. index actually permanently ceases to be available
IBOR Fallbacks: Changes to Documentation if Consultation Criteria Met (cont.)

- ISDA may also publish templates for standard modifications to allow, for example, a market participant who does not want the combined pre-cessation and permanent cessation fallback provisions to bilaterally negotiate terms outside of the standard ISDA Definitions and related Protocol.

- ISDA intends to design these templates so that they can be produced and negotiated on ISDA Create as well as in traditional paper format.

- As these would be individually negotiated, parties could, for example, agree to deviate from applying a spread adjustment that crystallises and remains the same on ②, provided that ② occurs before ④.

2020 Consultation on How to Implement Pre-Cessation Fallbacks in Derivatives
IBOR Fallbacks: Changes to Documentation if Consultation Criteria Not Met

- If the consultation criteria are not satisfied, the draft Supplement to the 2006 ISDA Definitions will be amended so as to include two LIBOR floating rate options: the current ‘permanent cessation’ LIBOR floating rate options + for each current ‘permanent cessation’ LIBOR floating rate option, a second separate floating rate option, which would contain a pre-cessation trigger in addition to the permanent cessation trigger. **This second rate option is equivalent to the current rate option as amended if the consultation criteria are satisfied (i.e. the ‘Amended Rate Option’ set out on Slide 13).**

- This separate floating rate option would therefore utilise different definitions of “Index Cessation Event” and “Index Cessation Effective Date”, which would include both the permanent cessation trigger and a pre-cessation trigger.

<table>
<thead>
<tr>
<th>Rate Option 1: USD-LIBOR-BBA (as currently drafted)</th>
<th>Rate Option 2: USD-LIBOR-Pre-cessation (separate new rate option)</th>
</tr>
</thead>
<tbody>
<tr>
<td>This will be equivalent to USD-LIBOR-BBA but will include (i) provisions dealing with temporary cessation, (ii) an Index Cessation Event trigger and (iii) a fallback to compounded SOFR plus spread* following an Index Cessation Event.</td>
<td>This will be the same as Rate Option 1 but will also include a pre-cessation trigger and a fallback to compounded SOFR plus spread* following that pre-cessation trigger.</td>
</tr>
<tr>
<td>* The spread will be calculated on the business day before the public statement/information constituting an Index Cessation Event by reference to historical data at that time (the “permanent cessation spread”).</td>
<td></td>
</tr>
</tbody>
</table>
IBOR Fallbacks: Changes to Documentation if Consultation Criteria Not Met (cont.)

• If the consultation criteria are not satisfied, the draft ISDA 2020 IBOR Fallbacks Protocol will be amended such that Rate Option 1 (e.g. USD-LIBOR-BBA) with only the permanent cessation trigger is hardwired into the Protocol.

• The Protocol will also set out Rate Option 2 (e.g. USD-LIBOR-Pre-cessation). If adhering parties wish to include the pre-cessation trigger alongside the permanent cessation trigger in all covered legacy contracts with all other adhering parties that also elect to include the pre-cessation trigger alongside the permanent cessation trigger in all covered legacy contracts, they would need to select ‘Rate Option 2’ in their adherence letter, which will override the hardwired Rate Option 1 with respect to any of their counterparties who also adhere and who also select ‘Rate Option 2’.

• Both adhering parties must elect for Rate Option 2 to apply for covered legacy contracts to be amended to include Rate Option 2 instead of Rate Option 1 (i.e. the LIBOR floating rate options which include the pre-cessation trigger and the permanent cessation trigger).
IBOR Fallbacks: Changes to Documentation if Consultation Criteria Not Met (cont.)

- ISDA may also publish **templates for standard modifications** to allow, for example, a market participant who wishes to include Rate Option 2 in *some* but not *all* covered legacy contracts to bilaterally negotiate terms outside of the standard ISDA Definitions and related Protocol. Similarly, where an entity wishes to include Rate Option 2 for each currency in legacy contracts but its counterparty has not elected to apply those Rate Options when adhering to the Protocol, it would need to bilaterally agree to this.

- ISDA intends to design these templates so that they can be produced and negotiated on ISDA Create as well as in traditional paper format.

- As these would be individually negotiated, parties who are electing Rate Option 2 for each currency could, for example, agree to deviate from applying a spread adjustment that crystallises and remains the same on the pre-cessation trigger event date, provided that the pre-cessation trigger event date occurs before the permanent cessation trigger event date.
IBOR Fallbacks: Changes to Documentation if Consultation Criteria Not Met (cont.)

• See below for some example elections and the related consequences under an amended version of the ISDA 2020 IBOR Fallbacks Protocol where the consultation criteria are not satisfied.

<table>
<thead>
<tr>
<th>Party</th>
<th>Election</th>
<th>Consequence</th>
</tr>
</thead>
</table>
| Party A | Rate Option 2 | **Party A/Party B**: pre-cessation trigger *not included* in any covered contracts between Party A and Party B  
*The counterparties could bilaterally agree to include the pre-cessation trigger in some or all of their legacy contracts* |
| Party B | None         | **Party B/Party C**: pre-cessation trigger *not included* in any covered contracts between Party B and Party C  
*The counterparties could bilaterally agree to include the pre-cessation trigger in some or all of their legacy contracts* |
| Party C | Rate Option 2 | **Party A/Party C**: pre-cessation trigger included in *all* covered contracts between Party A and Party C |
IBOR Fallbacks: Looking Ahead

• Later 2020:
  – Deadline for consultation responses: March 25, 2020
  – Publication of consultation results and announcement of next steps for implementing permanent cessation and pre-cessation fallbacks: Late April 2020 – Early May 2020
  – Publication of Bloomberg indicative fallback rates: First half of 2020
  – Publication of final form of Supplement to the 2006 ISDA Definitions and of ISDA 2020 IBOR Fallbacks Protocol: Targeting Q3 2020
  – Effectiveness of Supplement to the 2006 ISDA Definitions and of ISDA 2020 IBOR Fallbacks Protocol: 3-4 months after publication
IBOR Fallbacks: Questions

- **Question:** How can I submit questions regarding the consultation during the webinar?
  - **Answer:** Type your questions in the word box provided on the screen

- **Question:** How can I submit additional questions regarding the consultation after the webinar finishes?
  - **Answer:** Email: [FallbackConsult@isda.org](mailto:FallbackConsult@isda.org)
IBOR Fallbacks: General Background

• IOSCO Principles for Financial Benchmarks Principle 13
  – “Users should be encouraged to have robust fallback provisions in contracts or financial instruments that reference a benchmark in the event of cessation of the referenced benchmark.”

• FSB OSSG Market Participants Group Final Report (July 2014)
  – “In most cases, fallback provisions are not sufficiently robust for a permanent discontinuation of a key IBOR.”

• IOSCO statements to consider in the Use of Financial Benchmarks (December 2017)
  – “Users should therefore consider their contingency plans in the event a benchmark is no longer available or materially changes in order to mitigate the potential risks involved. Users are encouraged to produce and maintain clear, comprehensive and robust written policies and procedures on actions they would take in such an event. … Where feasible and appropriate, contingency plans for the cessation of a benchmark should include users’ having sufficiently robust fall back provisions in their financial contracts and instruments. These provisions should ideally involve at least one alternative or fall back rate and/or other figure as a substitute for the benchmark originally referenced should it no longer be available. Users should also seek to reflect their contingency plans in their contractual arrangements.”

2020 Consultation on How to Implement Pre-Cessation Fallbacks in Derivatives
IBOR Fallbacks: General Background (cont.)

- Financial Stability Board (FSB) Official Sector Steering Group (OSSG) letter to ISDA (July 2016)
  - Invites ISDA to participate in work to enhance the robustness of derivative contracts referencing widely used interest rate benchmarks and mitigate potential systemic risks that could arise if a key benchmark is permanently discontinued.
  - “…key goals should be that market participants understand the fall back arrangements that would apply if a permanent discontinuation of a key interest rate benchmark occurred, and that these arrangements should be robust enough to prevent potentially serious market disruption in such an event. This should include the possible scenario where an administrator is no longer able to determine a reference rate. Applicable contractual fall backs should ideally be used for existing derivatives contracts as well as future ones, and, in the EU, it will effectively be a regulatory requirement that they do so in some circumstances. Suitable arrangements could include a series of fall back rates…”

- ISDA response to FSB OSSG (September 2016)
  - “ISDA is well positioned to convene discussions regarding [derivative contract robustness] amongst its members and the public sector, our members representing major users of interest rate benchmarks in the global derivatives market from a wide variety of constituencies. We expect that these discussions would cover selection of fallbacks and, as you mention in your letter, development of an implementation plan for contractual adoption of such fallbacks. We also expect that any ultimate decisions and/or actions arising out of the discussions would require guidance and direction from the FSB OSSG and, potentially, legislation or regulation to ensure market-wide implementation.”

2020 Consultation on How to Implement Pre-Cessation Fallbacks in Derivatives
IBOR Fallbacks: Pre-cessation Background

• FSB OSSG letter to ISDA (March 2019)
  – Asks ISDA to consult on a potential trigger for fallbacks that would take effect in the event that the UK FCA (in its capacity as the regulator of LIBOR) finds that LIBOR ‘is no longer capable of being representative’ or is ‘non-representative’ and makes a statement to that effect. FSB OSSG letter specifically refers to consulting in respect of LIBOR (rather than all critical IBORs).
  – “While the Benchmark Regulation envisages some circumstances in which a critical benchmark that does not meet requirements of the Regulation (such as representativeness) continues to be published […] EU supervised entities would no longer be able to enter into new derivative or securities transactions referencing LIBOR in those circumstances.”

• ISDA Consultation on Pre-cessation Issues (May 2019)
  – Following the letter from the FSB OSSG, ISDA consults on pre-cessation issues. The majority of respondents state that generally they would not want to continue referencing LIBOR in derivative contracts following a public statement by the UK FCA that LIBOR was no longer representative. However, a wide variety of views are expressed regarding whether and how to implement a pre-cessation fallback trigger related to non-representativeness in derivatives.

• IFSB OSSG letter to ISDA (November 2019)
  – Following ISDA’s consultation on pre-cessation issues, FSB OSSG asks ISDA to accommodate the majority view and include a pre-cessation trigger alongside the permanent cessation triggers in the fallbacks it intends to implement in the 2006 ISDA Definitions and in the Protocol for inclusion of the definitions with the updated fallbacks in legacy contracts.
IBOR Fallbacks: Pre-cessation Background (cont.)

• ISDA response (December 2019)
  – ISDA responds to FSB OSSG, indicating that it remains focused on the timely delivery of a fallback solution, continuing to “finalize the work on permanent cessation fallbacks” while working with “regulators and the industry to increase market understanding of the implications of a “non-representative” LIBOR” and attempting to build “a consensus on how to implement pre-cessation fallbacks”.
  – ISDA indicates that the market needs further clarity from the UK FCA and IBA on the length of the “reasonable period” during which a ‘non-representative’ LIBOR would be published as well as from CCPs regarding the actions they would take if LIBOR were found to be ‘non-representative’.

• Market Engagement with ISDA request for clarification
  – LCH, CME, Eurex and IBA respond to ISDA’s December 2019 letter (Dec 2019).
  – LCH launches rulebook changes consultation to implement fallbacks following a pre-cessation trigger occurring (Jan 2020).
  – UK FCA sends a letter to ISDA providing additional information on a ‘non-representative’ LIBOR scenario (Jan 2020). The UK FCA indicate that it anticipates “limited willingness to contribute to a non-representative LIBOR for anything longer than the minimum period necessary to allow for an orderly cessation”.
  – IBA explains how it would respond to the UK FCA determining that LIBOR is ‘non-representative’ in letter to ISDA (Jan 2020).