Benchmark Reform at a Glance

Firms need to get ready for a possible discontinuation of LIBOR from the end of 2021. With this date looming, and amid a broader global initiative to transition from interbank offered rates (IBORs) to alternative benchmarks, firms can take a number of steps to reduce their exposure to the IBORs and prepare for the risk that a benchmark rate ceases to exist.
How can I reduce my exposure to LIBOR or another IBOR?

1: Enter into new transactions based on alternative rates.

- Alternative risk-free rates (RFRs) have been identified by public-/private-sector working groups in various jurisdictions:
  - Bank Bill Swap Rate ➞ AONIA (RBA Cash Rate)
  - CDOR ➞ CORRA
  - Euro LIBOR/EURIBOR ➞ €STR
  - HIBOR ➞ HONIA
  - Yen LIBOR/TIBOR/euroyen TIBOR ➞ TONA
  - Swiss franc LIBOR ➞ SARON
  - Sterling LIBOR ➞ SONIA
  - US dollar LIBOR ➞ SOFR

- Information about the IBORs and alternative RFRs, their administrators and the working groups that identified the alternative RFRs is available at www.isda.org/fallbacks.
- Firms could choose to use other alternative rates published in the relevant currency, so long as those rates are compliant with principles established by the International Organization of Securities Commissions.
- New transactions would use the ‘floating rate options’ and conventions (eg, day count, payment frequency) used for trading in the alternative rate:
  - Floating rate options are set out in the 2006 ISDA Definitions;
  - Central counterparties (CCPs) set the conventions for the clearing of products referenced to alternative rates;
  - Conventions for other types of derivatives that reference these rates (eg, swaptions and cross-currency swaps) are under consideration and/or in the early stages of development.

2: Consider voluntarily reducing IBOR exposure in legacy portfolios prior to an IBOR cessation.

- This involves bilateral negotiation between counterparties.
- Counterparties can choose between various models, including:
  - Amendments;
  - Novations;
  - Close-outs at the transaction or portfolio level and entry into new transactions;
  - Compression exercises that increase exposure to the alternative rates while reducing exposure to IBORs;
  - Entry into offsetting basis swaps.
- The resulting transactions would use the floating rate options in the 2006 ISDA Definitions for the alternative rates and would use conventions (eg, payment dates) agreed by the counterparties. For standard interest rate swaps, this would likely be the conventions used for trading in products based on the alternative rates as opposed to the original IBORs (this would be subject to negotiation and agreement).
What happens if I still have exposure to LIBOR (or another IBOR) at the time it is discontinued?

1: Under existing fallbacks for LIBOR (and most other IBORs), which are included in the floating rate options set out in the 2006 ISDA Definitions, the calculation agent would conduct one or more polls of major dealers (‘reference bank polls’) in the relevant locations to determine a fallback rate.

- It is probable this fallback mechanism would fail immediately in the event an IBOR ceases to exist. Even if it results in a rate for the first reset date, it is very unlikely the rate would be consistent globally. It is also highly unlikely this method would result in a rate on each of the remaining reset dates.
- Failure of this fallback mechanism would probably result in disputes among counterparties.

2: ISDA is updating the floating rate options for LIBOR and other IBORs to replace the reference bank polls with fallbacks comprising the relevant RFR plus a spread. These would apply if the applicable IBOR is permanently discontinued.

- It is important to note that separate fallbacks that are not based on the RFRs would apply if there is a temporary issue with the publication of the relevant IBOR (eg, due to a technical glitch).
- ISDA will also publish a protocol that allows parties to agree to include the updated floating rate options and related terms within contracts entered into prior to the effective date of the updates. Information about the entities that adhere to this protocol (and which therefore agree to amend their legacy contracts with all counterparties that also choose to adhere) will be available on the protocol section of the ISDA website within 24 hours of adherence.
- The amendments made by the protocol will take effect approximately four months after the protocol launches (this will be the same date that the updates to the 2006 ISDA Definitions take effect).

3: The new permanent cessation fallbacks will be calculated by combining the relevant compounded in arrears RFR and a spread adjustment based on a five-year historical median of the differences between the IBOR and RFR.

- The compounded in arrears calculation will be based on the compounding formula used in overnight index swaps (OIS), but a backward shift will apply to the period of calculation, so payment amounts are known at least two days before payments are due (this differs from the OIS market, where counterparties sometimes agree to a payment delay).
- The backward shift will be two days, but the updated floating rate options will contain a mechanism that will allow for changes that have the same effect as a longer backward shift to the extent it is necessary to ensure the all-in fallback rate is available at least two business days prior to the relevant payment date (based on the terms of the relevant contract).
- ISDA ran several market consultations to determine the adjustment methodologies. The consultations and results are available at www.isda.org/fallbacks.

1 And earlier versions of the ISDA Definitions for interest rate derivatives
4: If a permanent cessation of an IBOR occurs, the derivatives contract will reference the all-in fallback rate (i.e., the compounded RFR plus spread). This would start from the point the IBOR could not be observed for the relevant observation date because it had been permanently discontinued.

- Discontinuation could occur for all tenors of an IBOR at once or could occur for some tenors before others. If only certain tenors are discontinued but at least one longer tenor and one shorter tenor remain, then linear interpolation using the remaining tenors would apply prior to use of the new fallback.

5: Bloomberg will publish the all-in fallback rates.

- Publication will generally occur on a date that is around the end of the relevant period, as opposed to a date at the beginning of the relevant period (which is when the IBORs are currently published).
- Bloomberg will label each all-in fallback rate with the date the original IBOR would have been published, which is typically the reset rate or two days prior to the reset date (i.e., each fallback rate will correspond to an IBOR publication date). If the fallback rate for the relevant IBOR publication day is not available on or before the date that is two business days before the relevant payment date (based on the terms of the contract), counterparties will use the fallback rate for the most recent IBOR publication day that is available.
- Bloomberg will become the legal price source for the relevant floating rate option, as it will replace the price source for the original IBOR. Even though counterparties will be able to calculate the all-in fallback rates themselves, the results of those calculations will not be the legally binding price source.

6: If the permanent cessation fallbacks are triggered and apply, the terms of the confirmation will remain exactly the same. Specifically, this means:

- The floating rate option referenced in the contracts will remain unchanged (e.g., US dollar LIBOR contracts will continue to reference USD-LIBOR-BBA, but the price source within the description of USD-LIBOR-BBA will move to the Bloomberg publication of the new all-in fallback rates based on SOFR). As a result, the floating rate option will differ from OIS referencing the RFRs.
- The other conventions (e.g., payment dates, day count, payment frequency) for the original IBOR derivative will remain the same. As a result, the conventions will differ from OIS referencing the RFRs.
- However, in accordance with the terms of the new fallbacks embedded in the floating rate options, the observation date will generally move to a date that is around the end of the relevant period.

7: If a derivative continues to reference the non-amended provisions of the floating rate option for the relevant IBOR following a permanent discontinuation (i.e., the provisions that do not include the new fallbacks), then the reference bank polls will continue to apply.

- This would occur if the counterparties continue to have exposure to the IBOR via derivatives that were entered into before the effective date of the updates to the 2006 ISDA Definitions and they do not adhere to the ISDA IBOR Fallback Protocol or bilaterally agree to include the new permanent cessation fallbacks.
- These derivatives will have the same floating rate options as those that contain the new permanent cessation fallbacks, but the fallback rate will depend on reference bank polls as opposed to Bloomberg's publication of the all-in fallback rate.

8: Firms will need to determine how to differentiate between derivatives described in 6 and 7, given they will have floating rate options with the same name.

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2 This is different from OIS based on the RFRs, which do not have a published price source.
What is a ‘pre-cessation’ fallback for LIBOR?

1: A pre-cessation fallback for derivatives referenced to LIBOR would be triggered if the UK Financial Conduct Authority (FCA) announces that LIBOR is no longer capable of being representative (either immediately or as of a future date), even if it continues to be published (and therefore permanent cessation fallbacks would not apply).

2: On the date LIBOR is deemed to be no longer representative, the new pre-cessation fallbacks would apply to contracts in the same way as for contracts that incorporate permanent cessation fallbacks.

- Like discontinuation, non-representativeness could occur for all tenors of an IBOR at once or could occur for some tenors before others.
  If only certain tenors are non-representative but at least one longer tenor and one shorter tenor continue to be published and remain representative, linear interpolation using remaining representative tenors would apply prior to use of the new fallback rates.

3: ISDA is updating the floating rate options for LIBOR (but not for other IBORs) to replace the reference bank polls with fallbacks to an adjusted version of the relevant RFR plus a spread that would apply if LIBOR is permanently discontinued or is no longer representative based on a determination by the UK FCA but continues to be published (including if it continues to be published as a ‘synthetic’ LIBOR).

4: If LIBOR continues to be published after it is no longer representative, contracts that do not include the updated floating rate options with the combined permanent cessation and pre-cessation fallbacks would continue to reference LIBOR in the form that it is published (unless counterparties voluntarily amend them).

5: The floating rate options would remain the same for: (a) LIBOR contracts that are not amended and therefore fall back to a reference bank poll upon permanent cessation (or any non-publication); and (b) LIBOR contracts that fall back to the all-in fallback rate published by Bloomberg following a permanent cessation or a non-representativeness determination. Firms will therefore need to differentiate between these two sets of derivatives.
About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 925 member institutions from 75 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association’s website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.