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LIBOR Transition for Derivatives

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Key Take-aways

1.
The end of LIBOR is approaching. Panel banks may cease to make submissions as of the end of 2021 and LIBOR benchmarks may cease to be representative soon thereafter as a result.

2.
For transactions with a term beyond 2021, in order to achieve a predictable outcome and avoid litigation risks, parties should incorporate fallback clauses into the contracts.

3.
Such fallback clauses may be incorporated into legacy transactions by adherence to an ISDA Fallbacks Protocol to be published soon. Alternatively, parties may agree to fallback clauses in bilateral amendment agreements.

1 LIBOR coming to an end

The fate of the **LIBOR benchmarks** was sealed when Andrew Bailey, the chairman of the Financial Conduct Authority (FCA) at the time, stated in July 2017 that "it would no longer be necessary for the FCA to persuade, or compel, banks to submit to LIBOR" by the end of 2021. Regulators have since then maintained the position that LIBOR should cease to exist around the **end of 2021** and a transition to **alternative risk-free rates** is required prior to such cessation. Nevertheless, LIBOR benchmarks are still widely used for products traded today, in particular in the **interest rate derivatives** and **loan markets** and for **floating rate notes**.

LIBOR is currently administered by ICE Benchmark Administration Limited (IBA) and available each business day in **five currencies** (USD, GBP, CHF, JPY and EUR) and **seven maturities** (overnight, one week, one month, two months, three months, six months, and twelve months). The LIBOR values are determined on the basis of submissions by panel banks.

Panel banks may withdraw from the submission process at different times as of the end of 2021 and, as a result, the FCA may decide that some LIBOR values are no longer representative before the LIBOR values cease to be published.

2 Use or Risk-free Rates (RFRs)

The national working groups in the relevant markets have identified the following RFRs that may be used as **alternative to the LIBOR** and their EU and Japanese equivalent (EURIBOR and TIBOR, together with LIBOR the **IBORs**): (i) CHF (CHF-LIBOR): Swiss Average Rate Overnight (**SARON**); (ii) USD (USD-LIBOR): Secured Overnight Financing Rate (**SOFR**); (iii) GBP (GBP-LIBOR): Sterling Overnight Index Average (**SONIA**); (iv) AUD (BBSW): Australia Overnight Cash Rate (**AONIA**); (v) JPY (JPY-LIBOR, TIBOR, Euroyen-TIBOR): Tokyo Overnight Average Rate (**TONA**); (vi) CAD (CDOR): Canadian Overnight Repo Rate Average (**CORRA**); (vii) HKD (HIBOR): HKD Overnight Index Average (**HONIA**); (viii) EUR (EUR-LIBOR, EURIBOR): Euro Short Term Rate (**EuroSTR**).

The **RFRs** are – as opposed to IBORs – **overnight rates**. As a result, if they shall be used in respect of a calculation period exceeding one day, the daily rates must be adjusted by a compounding for the relevant term.

As regards the EUR, while the EURIBOR shall continue to exist, EUR-LIBOR values will cease to be published in the context of the LIBOR cessation.

In respect of some RFRs, forward-looking term rates, which will be determined on the basis of derivatives transactions regarding such RFRs as underlyings, may be published in addition to the RFRs (e.g. for USD and GBP). The national working group expects that this will not be the case for Switzerland in the absence of a sufficiently liquid SARON futures market.

3 Fallbacks for Transactions in the Derivatives Market

As regards transactions referencing a LIBOR rate instead of an RFR and entered into with a term **beyond** the effective date of the LIBOR cessation or the date the FCA determines LIBOR is no longer representative, the question arises how such transactions can be transitioned during their respective term to an alternative risk-free rate. This may occur by agreeing to fallback clauses either by including such clauses into the transaction documentation when the transaction is entered into or by amending the transaction to that effect.

A **fallback clause** must specify the **triggers** for the transition to the fallback rate. The clause must also determine the **alternative risk-free rates** that will apply upon a trigger event becoming effective and specify the adjustments that shall apply with respect to the move to the relevant fallbacks. These adjustments include a **term adjustment** to address the differences in the term structure of the two rates (i.e. the move from a forward-looking term rate to an overnight rate) and a **spread adjustment** taking into account any differences with respect to credit risk (i.e. the move from a rate addressing interbank credit exposure to a rate based on secured transactions or transactions traded in a wider market).

ISDA intends to implement the relevant fallback clauses in a supplement to the 2006 ISDA Definitions, which are the relevant ISDA definitions applicable to interest rate benchmarks, and in a "Protocol" (ISDA Fallbacks Protocol) for inclusion of the fallbacks into pre-existing transactions.

Parties will have to agree to fallback clauses prior to the end of 2021.

3.1 Trigger Events

Each of the following events may constitute a trigger:

i. a public statement or publication by or on behalf of the **relevant administrator** of the relevant IBOR announcing that it has ceased or will cease to provide the relevant IBOR permanently or indefinitely, provided that there is no successor that will continue to provide the relevant IBOR;

ii. a public statement or publication by the **regulatory supervisor** for the administrator of the IBOR, the central bank for the currency of the relevant IBOR, an insolvency official with jurisdiction over the administrator of the IBOR, a resolution authority with jurisdiction over the administrator of the IBOR or a court or an entity with similar insolvency or resolution authority over the administrator of the IBOR, which states that the administrator of the IBOR has ceased or will cease to provide the IBOR permanently or indefinitely, provided that there is no successor that will continue to provide the relevant IBOR; and

iii. a regulator determining that a LIBOR rate has ceased to be representative, which shall constitute a contractual trigger for a fallback (**pre-cessation trigger**).

For i. and ii., the effective date of such events may be at a later point in time than the occurrence of the relevant event. For instance, if the administrator of a relevant IBOR announces in advance that it will cease to publish the relevant IBOR at a certain date in the future, the event would have occurred as of such announcement, but the fallbacks will only apply on the future date when the publication of the IBOR will cease.

3.2 Definition of alternative risk-free rates

The 2006 ISDA Definitions and the ISDA Fallbacks Protocol will include provisions mapping the relevant IBORs to an alternative risk-free rate.

3.3 Term Adjustment

As regards the term adjustment, ISDA consulted with the derivatives market participants as regards the approach to be taken to address the differences in the tenors between IBORs and the overnight risk-free rates. The result of these consultations showed a preference of the derivatives market for a "**compounded setting in arrears**" rate to be determined in respect of each IBOR tenor and a "**lookback/backward-shift**" of the calculation period by two banking days for the determination of the term adjusted overnight risk-free rate. It is the intention that the 2006 ISDA Definitions and the ISDA Fallbacks Protocol will include such term adjustments for the risk-free rates. Therefore, as of the first interest period after the relevant trigger event becoming effective, the calculation would be made on the basis of a calculation period determined with such "lookback/backward-shift" method.

3.4 Spread Adjustment

To address the differences in the credit and liquidity risk and further factors, such as fluctuations in supply and demand between the relevant IBORs and the alternative risk-free rates, a spread should be taken into account (**spread adjustment**).

ISDA also sought the views of the derivatives market participants as regards the methodology to be applied for such spread adjustment. The outcome was a preference for the calculation of a **historical median** over a **five-year lookback** period as opposed to a calculation on the basis of a mean, which would be calculated over a longer look-back period.

3.5 Publication of adjusted alternative risk-free rates

It is ISDA's intention that Bloomberg shall publish the term- and spread-adjusted alternative risk-free rates in the relevant tenors. For each such tenor, Bloomberg shall publish three values: the term-adjusted overnight risk-free rate, the relevant spread and an "all-in" rate as the aggregate of the term-adjusted overnight risk-free rate and the spread.

4. Methods to incorporate Fallbacks into Derivatives Transactions

4.1 Pre-existing Transactions

ISDA Fallbacks Protocol

As regards the inclusion of fallbacks into pre-existing transactions, the parties may adhere to the **ISDA Fallbacks Protocol** once it has been published.

ISDA intends to cover not only transactions entered into under ISDA Master Agreements or by reference to the 2006 ISDA Definitions, but to apply a broader scope, covering also some transactions entered into under non-ISDA documentations, provided that they include cashflows that are determined by reference to a relevant IBOR. This will cover (i) Swiss Master Agreements for OTC Derivative Instruments published by the Swiss Bankers Association (including (a) the 2003 version, (b) the 2013 version for use in connection with certain ISDA Definitions and (c) the 2013 non-ISDA version not for use in connection with any ISDA Definitions), (ii) Swiss Master Agreements for Repo Transactions published by the Swiss Bankers Association (bilateral 1999 version, multilateral 1999 version) and (iii) Swiss Master Agreements for Securities Lending and Borrowing prepared by the Swiss Bankers Association (2011 version)(together the Swiss Master Agreements).

Also, the ISDA Fallbacks Protocol would amend certain collateral documentations by incorporating the relevant fallback clauses for the purposes of the calculation of interest payments.

Bilateral Agreement

As an alternative to adhering to the ISDA Fallbacks Protocol, parties to derivatives transactions may enter into a **bilateral agreement** for the purposes of including the relevant fallback clauses into pre-existing transactions.

The Swiss Bankers Association intends to publish a **Swiss IBOR Appendix** that may be entered into as such bilateral agreement as regards Swiss Master Agreements and transactions entered into thereunder. It is the intention that the Swiss IBOR Appendix shall cross-refer to the fallbacks specified in the ISDA Fallbacks Protocol.

4.2 New Transactions

The fallback clauses will be included in a **supplement to the 2006 ISDA Definitions**. As a result, as of the go-live date of such supplement, any derivatives transactions documented in a confirmation referring to the 2006 ISDA Definitions will automatically include such fallbacks specified in the supplement to the 2006 ISDA Definitions.

To the extent that parties enter into the Swiss IBOR Appendix, the fallback clauses incorporated in the ISDA Fallbacks Protocol should also apply to any new transactions entered into between the parties to a Swiss Master Agreement after the signing of the Swiss IBOR Appendix.

5 Approach for Tough Legacy Transactions

For transactions, where the parties to derivatives transactions referencing LIBOR rates fail to agree to the inclusion of fallback clauses (**Tough Legacy Transactions**) with one of the methods specified under (4) above, the question arises whether regulatory authorities will step in and provide for a continued publication of LIBOR and, if so, on what conditions.

In England, the FCA may be given the power, on the premise that it has taken a decision that LIBOR for a certain currency is no longer representative, to step in and mandate the continued publication of LIBOR values (synthetic LIBOR) on the basis of alternative risk-free rates for a limited time period if required for an orderly transition. However, the FCA may only make use of this power if a large part of the market has included fallback clauses in the documentation. At this stage, it is not certain whether, how and for how long a synthetic LIBOR values would be determined.

6 Conclusion

To achieve a **predictable outcome**, the parties will have to adhere to the ISDA Fallbacks Protocol when it is open for adherence or agree in bilateral agreements to include fallback clauses into the documentation in advance of the LIBOR cessation or a regulator determining that LIBOR has ceased to be representative.




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