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IBOR FALLBACKS FOR DERIVATIVES – ISDA CONSULTATION ON TERM AND SPREAD ADJUSTMENTS FOR FLOATING RATES

ISDA released its "Consultation on Certain Aspects of Fallbacks for Derivatives Referencing GBP LIBOR CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW" on 12 July 2018. The Consultation seeks feedback on proposed amendments to the 2006 ISDA Definitions to address fallbacks to the applicable risk-free rates ("RFRs") for derivatives in circumstances where an associated IBOR is not available. Whilst the Consultation does not seek to address whether the adjusted RFRs and credit spread adjustments would be appropriate for fallbacks in non-derivative securities, such as loans and bonds, it is an important step in attempting to establish a market consensus as part of an orderly transition away from key IBORs.

BACKGROUND AND SCOPE OF THE CONSULTATION

This work of ISDA is being undertaken against the background of the initiatives of the Financial Stability Board ("FSB") on interest rate benchmark reform. More particularly, in July 2016 the FSB Official Sector Steering Group ("OSSG") requested ISDA to lead the initiative on increasing derivative contract robustness against the risk that a key interest rate benchmark could be discontinued permanently.

The Consultation seeks feedback on the approach for calculating the adjusted RFRs and the spread adjustments which will apply to the RFRs if the fallbacks are triggered. Such adjustments are required in order to try to ensure that if the fallback is triggered, the replacement rate will be comparable with and, as far as possible, economically equivalent to the original rate.

Term Rates vs Overnight Rates: The RFRs are overnight rates but the relevant IBORs are published for various terms (1-month, 3-month, 6-month etc). To account for the move from a “term” rate (the IBOR) to an overnight rate (the overnight RFR), the fallbacks to be implemented by ISDA will apply an adjustment to each overnight RFR so that it is comparable to the relevant IBOR (the “adjusted RFR”).

Key issues

- Consultation seeks feedback on term and spread adjustments for derivatives fallbacks based on RFRs.
- Four options to account for the move from a term rate to an overnight rate.
- Three options to calculate a spread adjustment.
- Covers GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW.
- Open to all market participants
- Focusses on fallbacks for derivatives - the consultation makes clear that it does not address whether the adjusted RFRs and spread adjustments would be appropriate for fallbacks in non-derivative securities (e.g., loans, bonds).
- Consultation open until 12 October 2018.

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The Consultation sets out four options to account for the move from a term rate to an overnight rate: a spot overnight rate; a convexity adjusted overnight rate; a compounded setting in arrears rate; and a compounded setting in advance rate (see text box for further details).

Spread Adjustment for Risk Free Rates Beyond this, the overnight RFRs are risk-free, or nearly risk-free, whereas the relevant IBORs incorporate a premium for bank credit risk and for a variety of other factors, such as liquidity and fluctuations in supply and demand. While it is recognised that it would not be possible to replicate such factors upon a permanent discontinuation of the relevant IBOR, a spread adjustment can function as a rough approximation for the relevant adjusted RFR.

To calculate a spread adjustment three options are proposed: a forward approach; a historical mean/median approach; and a spot-spread approach (see text box for further details).

The Consultation is open to all market participants, not just derivatives market participants. However, the Consultation makes clear that it does not seek to address whether the adjusted RFRs and credit spread adjustments would be appropriate for fallbacks in non-derivative securities, such as loans and bonds.

In addition, the Consultation contemplates fallbacks based on the overnight RFRs rather than to fall back to RFR-derived term rates. This reflects the view of, for example, the FSB that the extensive use of derivatives dictates that they should refer to the most robust rates - and the most robust replacements for the IBORs referenced in the derivatives markets are the overnight RFRs, because they are firmly and consistently grounded in transactions from active markets. Using fallbacks based on the overnight RFRs is also consistent with the FSB OSSG's message that ISDA should develop fallbacks that could be used in the absence of suitable term rates.

Nevertheless, participants in markets other than derivatives should consider the Consultation in light of the inter-relationships between products and whether any of the proposals set out in the Consultation could be considered for their own markets.

In terms of currencies, the Consultation covers GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW. ISDA notes that it will launch supplemental consultations covering USD LIBOR, EUR LIBOR and EURIBOR.

BUILDING ON THE CONSULTATION FEEDBACK

ISDA will assess the responses to the Consultation and, based on those responses, will select the approach for calculating the adjusted RFR and spread adjustment. ISDA will also publish a full explanation of how it made its determination. However before implementing any changes to its standard documentation, ISDA will publish the final approach for review and comment.

Following selection of the approach for calculating the adjusted RFR and spread adjustment, ISDA will work with an independent third-party vendor to build out and finalize the chosen approach. It will be the responsibility of such independent third-party vendor to obtain the data necessary to perform the relevant calculations, run the calculations and publish the adjusted RFR and the spread adjustment so that users can access the information in the same way that they access the relevant IBOR or RFR.

Possible Approaches to Term Adjustments

- Spot Overnight Rate – the RFR that sets on the date that is one/two business days prior to the beginning of the relevant IBOR tenor.
- Convexity-adjusted Overnight Rate – similar to the spot overnight rate but attempts to account for the difference between flat overnight interest at the spot overnight rate versus the realized rate of interest that would be delivered by daily compounding of the RFR over the relevant IBOR term.
- Compounded Setting in Arrears Rate – the RFR observed over the relevant IBOR tenor and compounded daily during that period.
- Compounded Setting in Advance Rate – similar to compounded in arrears rate but with an observation period ending prior to the start of the relevant IBOR tenor.

Credit Spread Methodologies

- Forward Approach – calculated based on observed market prices for the forward spread between the relevant IBOR and RFR in the relevant tenor at the time the fallback is triggered.
- Historical Mean/ Median Approach – based on the mean or median spot spread between the relevant IBOR and RFR calculated over a significant, static lookback period (e.g., 5 or 10 years).
- Spot-Spread Approach – based on the spot spread between the relevant IBOR and RFR on the day preceding the relevant announcement or publication of the event triggering the fallback.

CONCLUSION

The Consultation is clearly an important step in seeking to establish a market consensus in situation where regulators have made clear that the selection of IBOR fallbacks must be market-led solution and one led by the private sector.

However, for an orderly market transition away from certain key IBORs and to the adoption of alternative risk-free rates it is vital to ensure co-ordination across product areas – that whichever solution is adopted for derivatives works for all – both for the derivatives markets and for the cash markets.

The Consultation quite deliberately contemplates fallbacks for derivatives based on the overnight RFRs rather than falling back to RFR-derived term rates. However, the FSB has recognised that an overnight RFR may not be the optimal rate in all the cases where term IBORs are currently used and that term rates could also form part of a fallback in some cash-product contracts which reference an IBOR, notably where that contract requires planned interest or coupon payments based on a forward-looking rate.

It is then crucial to any orderly transition that, to the extent there are different approaches across the different markets to issues such as the use of term rates, such approaches are compatible with each other.

The Consultation is one of a number of significant steps already taken towards a transition away from LIBOR before the end of 2021. However, this transition is still only at an early stage. As Andrew Bailey noted on the same day the Consultation was issued, there is still much further to go.

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