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IBOR FALLBACKS FOR DERIVATIVES – ISDA'S SUPPLEMENTAL CONSULTATION ON TERM AND SPREAD ADJUSTMENTS FOR FLOATING RATES AND ITS CONSULTATION ON PRE-CESSATION ISSUES

ISDA has released two further consultations on benchmark fallbacks. One consultation covers spread and term adjustments for US dollar LIBOR, Canada's CDOR and Hong Kong's HIBOR. The second consultation seeks input on how derivatives contracts should address a situation where certain key IBORs are no longer representative of an underlying market. Together they represent a significant further step in ISDA's on-going work on developing fallbacks for interest rate derivatives.

BACKGROUND - ISDA'S INITIAL CONSULTATION OF JULY 2018

The initial ISDA Consultation on benchmark fallbacks was released in July 2018 and covered spread and term adjustments for sterling LIBOR, Swiss franc LIBOR, Yen LIBOR, Yen TIBOR, Euroyen TIBOR and the Australian Bank Bill Swap Rate (BBSW). The consultation set out four options to account for the move from a term rate to an overnight rate and three options to calculate a spread adjustment. For details see our July 2018 briefing.

The results of that consultation, announced in December 2018, found that the overwhelming majority of respondents preferred the 'compounded setting in arrears rate' for the adjusted risk-free rate, and a significant majority across different types of market participant preferred the 'historical mean/median approach' for the spread adjustment.

SUPPLEMENTAL CONSULTATION ON SPREAD AND TERM ADJUSTMENTS FOR USD LIBOR, CDOR AND HIBOR

This ISDA consultation was released on 16 May 2019 and is supplemental to and seeks to build on the responses to ISDA's July 2018 Consultation.

It sets out options for term and spread adjustments which will apply to the relevant risk-free rates ("RFRs") if fallbacks are triggered for derivatives

Key issues:

- **A supplemental ISDA consultation** on spread and term adjustments for USD LIBOR, Canadian CDOR, Hong Kong HIBOR.
- Seeks to build on ISDA's July 2018 Consultation on GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW.
- Gives respondents the option to affirm that their responses to the ISDA's July 2018 consultation apply equally to the questions in this supplemental consultation on USD LIBOR, Canadian CDOR and Hong Kong HIBOR
- The results of the ISDA July 2018 consultation supported the 'compounded setting in arrears rate' for the adjusted risk-free rate and preferred the 'historical mean/median approach' for the spread adjustment.

- **A new ISDA consultation** on pre-cessation issues for LIBOR and certain other IBORs.
- Addresses the situation where certain key IBORs are no longer representative of an underlying market.

- Both consultations are open to all market participants.

referencing US dollar LIBOR, the Hong Kong Interbank Offered Rate ("HIBOR") and the Canadian Dollar Offered Rate ("CDOR").

The consultation refers to same three options for spread adjustments and the four options for term adjustments as were contained in the July 2018 Consultation (see text box). Moreover, it gives respondents the option to affirm that their responses to the questions in that July 2018 Consultation apply equally to the questions in this supplemental consultation in relation to USD LIBOR and its fallback SOFR; CDOR and its fallback CORRA; and HIBOR and its fallback HONIA.

Based on the responses to this consultation, ISDA will determine the appropriate approach to implementing fallbacks for these additional currencies and whether this should be the same approach as is being implemented for the currencies covered by the July 2018 Consultation.

Beyond this, the consultation poses two questions not addressed in the July 2018 Consultation.

Firstly, the consultation seeks feedback on a proposed fallback for the Singapore Swap Offer Rate ("SOR") following a permanent cessation of USD LIBOR, given that USD LIBOR is currently used as an input to calculate the Singapore rate and that therefore a cessation of USD LIBOR would consequently result in a cessation of SOR.

SOR is based on actual transactions in the USD/SGD FX swap market and utilises USD LIBOR as the applicable USD interest rate. The proposed adjusted SOR would, in the event of a permanent cessation of USD LIBOR, refer to the fallback for USD LIBOR, namely adjusted SOFR plus a spread adjustment.

The second additional question is in relation to the "historical mean/median approach" for spread adjustment, which requires the use of historical data relating to the RFR to calculate the spread. Under the "historical mean/median approach" the proposed lookback period would be five or even 10 years. The RFR fallback for USD LIBOR is SOFR, but the Federal Reserve Bank of New York only started officially publishing SOFR in April 2018. However the consultation notes that there is the historical Overnight Treasury GC Repo Primary Dealer Survey Rate (which serves as a proxy for SOFR with a few technical differences) for which data is available from February 1998.

Given this, the consultation asks whether, in the event that USD LIBOR is discontinued before SOFR data is published for the entire lookback period, such historical proxy data could be used when calculating the spread adjustment in respect of adjusted SOFR.

CONSULTATION ON PRE-CESSATION ISSUES FOR LIBOR AND CERTAIN OTHER IBORS

The second ISDA consultation released on 16 May 2019 explores how derivatives contracts should address a regulatory announcement that LIBOR or certain other interbank offered rates ("IBORs") categorized as critical benchmarks under the EU Benchmarks Regulation are no longer representative of an underlying market.

This consultation follows a request by the Financial Stability Board's Official Sector Steering Group (FSB OSSG) for ISDA to seek market input on the events that should trigger a move to a spread-adjusted fallback rate for LIBOR. The consultation also follows recent statements by the UK Financial Conduct Authority (FCA) suggesting that market

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.

participants may wish to consider including in their LIBOR contracts "pre-cessation" fallback triggers based on an announcement by the FCA that LIBOR is no longer representative, in addition to fallback triggers based on permanent cessation.

The consultation on pre-cessation issues does not cover yen TIBOR, euroyen TIBOR, BBSW, HIBOR or CDOR. The consultation covers SOR only insofar as to consider if the SOR fallback for a US dollar LIBOR index cessation event should also apply in the event of a US dollar LIBOR pre-cessation trigger.

The consultation also notes that, in discussions held at the instigation of the FSB OSSG, the Central Counterparties CME and LCH have each communicated to ISDA and regulators that public determination by a regulator of the administrator of a rate that it is no longer representative would be a directly relevant factor in their assessment of whether the rate continues to be robust or fit for purpose. In addition the consultation notes that the adoption of pre-cessation triggers for fallbacks across both cleared and uncleared derivatives would mitigate the risk of a hedging mismatch across such derivative contracts.

Questions posed by the consultation include: the actions derivative market participants would expect to take if LIBOR or another relevant IBOR is determined to be "nonrepresentative"; implications for hedges; implications of moving to an adjusted RFR if LIBOR or another relevant IBOR continues to be published; and the most appropriate documentation solutions (e.g., protocols) for addressing pre-cessation issues.

Given that this consultation addresses pre-cessation triggers as opposed to the situation following a permanent cessation of an IBOR, ISDA notes that anything implemented as a result of this consultation would be in addition to the fallbacks ISDA expects to implement to address a permanent cessation of a key IBOR.

CONCLUSION

Efforts to prepare for the use of RFRs as an alternative to LIBOR and other IBORs continue to gather momentum.

ISDA will publish a further consultation seeking input from market participants on open issues associated with the final parameters of the term and spread adjustments. It currently expects this to be released sometime in August 2019. In addition, ISDA is currently running a request-for-proposal process to select an independent third-party vendor to build out and prepare to publish the compounded setting in arrears rate and the historical mean/median spread adjustment. These various workstreams will the culminate in the publication of the amended 2006 ISDA Definitions, which will include the RFR fallbacks for benchmarks. This publication is now planned for December 2019, with the expected effective date to be March 2020.

However ISDA, reflecting the views of regulators, has made clear that it believes that the best strategy for market participants concerned about the cessation of an IBOR is to take action early. Derivatives markets are therefore expected actively to transition away from the IBORs and work is underway in the public-private sector RFR working groups to consider various potential strategies for derivatives market participants to achieve such a transition. This could be effected by closing out transactions which reference the IBORs, through multilateral compression or by replacing references to the IBORs with references to another rate (such as the relevant RFR, adjusted as appropriate) on a bilateral basis before the relevant IBOR is discontinued.

But there is also a recognition of the need for a safety net that will allow derivatives contracts which still reference LIBOR and other IBORs to survive a discontinuation of the underlying benchmark with the minimum possible market disruption. These two consultations are an important further step towards the goal of establishing such a safety net.

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