CLIFFORD CHANCE

ISDA IBOR FALLBACKS SUPPLEMENT AND PROTOCOL: KEY CONSIDERATIONS

– THOUGHT LEADERSHIP

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ISDA's IBOR Fallbacks Supplement and Protocol have been finalised and will be released on 23 October 2020. The IBOR Fallbacks Supplement updates rate options in the 2006 ISDA Definitions to include new risk-free rate fallbacks for the five LIBOR rates together with eight other IBOR benchmarks. The Supplement, when it becomes effective on 25 January 2021, will implement these risk-free rate fallbacks into the terms of new transactions and the Protocol will enable adhering parties to implement these fallbacks into the terms of legacy transactions. The broad scope of the amendments made by the Protocol, the range of agreements it covers and the availability of a series of templates and amendment agreements which can be used to tailor the terms of adherence, confront parties contemplating adherence with a series of challenges. These challenges will require extensive due diligence to be undertaken both with respect to a party's own documentation and also with respect to each of its counterparties. Moreover, these challenges and the key decisions they entail will need to be addressed in a very limited period of time.

ISDA IBOR FALLBACKS SUPPLEMENT

The **supplement to the 2006 Definitions** incorporating the new fallbacks (the "Supplement") will be released on 23 October 2020 (the "Launch Date") and will take effect in new transactions on 25 January 2021 (the "Supplement Effective Date").

What rates does it cover?

The Supplement introduces new fallback provisions (and specified adjusted risk-free rates as fallbacks) for the following IBORs: GBP LIBOR (SONIA), CHF LIBOR (SARON), U.S. dollar LIBOR (SOFR), euro LIBOR (EurSTR), EURIBOR (EurSTR), JPY LIBOR (TONA), TIBOR (TONA), the euroyen TIBOR (TONA), Australian BBSW (RBA Cash Rate), Canadian CDOR (CORRA), Hong Kong HIBOR (HONIA), Singapore SOR and the Thai THBFIX (each a "Relevant IBOR"). USD LIBOR is used as an input for SOR and THBFIX and so their respective fallbacks include a calculation which refers to the fallback for U.S. dollar LIBOR (i.e. term adjusted SOFR plus a spread).

These new fallbacks replace existing fallbacks whereby a calculation agent would conduct one or more polls of major dealers. The move to new fallbacks reflects a recognition of the risk that if a relevant IBOR were to be permanently discontinued it is unlikely that dealers would be willing or able to provide the required quotes.

When the Supplement is published and becomes effective on the Supplement Effective Date, the 2006 ISDA Definitions will include the new risk-free rate fallbacks. As a result, if the 2006 ISDA Definitions are incorporated by parties into the terms of transactions entered into on or after the Supplement Effective Date, the new fallbacks will apply to such transactions.

What events will trigger a fallback?

Each Relevant IBOR will be replaced by the relevant adjusted risk-free rate following a permanent cessation of the Relevant IBOR.

In respect of the five LIBOR rates only (GBP, USD, EUR, JPY and CHF), a pre-cessation trigger also applies. This will be triggered by an announcement by the UK regulatory supervisor for the administrator of LIBOR (currently the FCA) that the relevant LIBOR rate is not, or as of a specified future date will no longer be, representative and that representativeness will not be restored.

What are the fallback rates?

Pursuant to the terms of the Supplement, if a permanent cessation trigger or (if applicable) a pre-cessation trigger occurs (and assuming interpolation using other tenors of the Relevant IBOR is not possible) each of the Relevant IBORs will first fall back to a term adjusted risk-free rate for the relevant currency plus a spread adjustment.

The term adjusted rate for an IBOR will be the relevant risk-free rate for that IBOR compounded in arrears over an accrual period corresponding to the tenor of the IBOR (e.g. 1, 3, 6 months).

The spread adjustment will be the historic median difference between the relevant IBOR and the risk free rate over a five year lookback period.

In addition, a backward shift will apply to the calculation period for the adjusted risk-free rate, so payment amounts will be known at least two days before payments are due.

On permanent cessation, the fallback rates will not apply until actual cessation of the relevant IBOR (or, if earlier, for LIBOR rates, the date on which the LIBOR rate actually becomes non-representative).

However, the spread adjustment will be calculated at the time that the cessation event (or pre-cessation event) is announced.

If both a permanent cessation trigger and a pre-cessation trigger occurs, including for example where a permanent cessation is announced to take effect on a future date but prior to this future date there is an announcement of non-representativeness, then the spread adjustment will be as calculated at the time of whichever is the earlier trigger event.

Where will the adjusted risk-free rates be published?

Bloomberg Index Services Limited ("Bloomberg") was appointed by ISDA as the adjustment services vendor to calculate and publish the spread adjustment and the term adjustment as well as the "all-in" fallback rate.

Bloomberg has been publishing these rates on an "indicative" basis since 21 July 2020, showing what the fallback rates, including the spread, would be if a trigger event were to occur "today".

Following the occurrence of a trigger event and the fixing of the spread adjustment, Bloomberg will continue to

Key issues

- ISDA IBOR Fallbacks Supplement and ISDA 2020 IBOR Fallbacks Protocol to be released on 23 October 2020.
- Effective date of both the Protocol and of the Supplement 25 January 2021.
- Protocol enables market participants to incorporate some or all of the terms in the Supplement into a wide range of contracts, including but not limited to ISDA Master Agreements, CSAs and confirmations.
- Bilateral amendment agreements and templates enable tailoring of the scope of the Protocol.
- Parties contemplating adherence to the Protocol face a series of key challenges and decisions.
- Parties will need to conduct extensive due diligence both with respect to their own documentation as well as with respect to each of their counterparties.
- There have been clear indications from key regulators of the importance not only of adhering to Protocol but also of doing so prior to the Protocol effective date of 25 January 2021.

publish the fallback rates, which will be the compounded in arears adjusted RFR plus the fixed spread adjustment.

HOW THE ISDA 2020 IBOR FALLBACKS PROTOCOL WORKS

Where two parties adhere to the **ISDA 2020 IBOR Fallbacks Protocol** (the "Protocol"), it will amend legacy transactions between them so that upon the occurrence of a permanent cessation trigger or pre-cessation trigger (for the 5 LIBOR rates) of an IBOR, a robust RFR-based fallback will apply.

What agreements will the Protocol apply to?

The Protocol applies where: (i) the relevant document (master agreement, credit support document, confirmation) incorporates the 2006 ISDA Definitions, the 2000 ISDA Definitions or one of the equivalent earlier legacy ISDA definitions booklets; (ii) the relevant document references a relevant IBOR as defined in one of the definitions booklets without incorporating the definitions booklet itself; or (iii) the relevant document just references a relevant IBOR without any direct or indirect reference to an ISDA definitions booklet.

In addition, some non-ISDA documents will be within scope of the Protocol but only if those documents are listed in the Protocol as "Additional Master Agreements" or "Additional Credit Support Documents".

How do parties adhere to the Protocol?

A party wishing to adhere will need to sign and upload an adherence letter to the ISDA Protocol site. The Protocol will be open for public adherence from the Launch Date. ISDA will publish a list of adhering parties on its website which will be updated on an ongoing basis.

The agreement between two adhering parties to make the amendments contemplated by the Protocol will be effective on the date on which adherence of the second party is effective (the "Implementation Date"). However, the amendments as between those two adhering parties will actually be made from the later of (a) 25 January 2021 (the "Protocol Effective Date") and (b) if later, the date on which both parties have effectively adhered to the Protocol.

It is also open to parties to adhere in escrow in the period up to the Launch Date. Such adherence will be binding but the adhering entity's name will not appear on the ISDA website until the Launch Date. ISDA has indicated that wide take up of this 'adherence in escrow' process will result in a broad list of adherents at the Launch Date and will thereby indicate to the market an expectation of wide usage of the new fallbacks. There has also been encouragement from key global regulators that regulated entities not only should adhere to the Protocol but should do so, in the case of certain regulated entities, during the escrow period prior to the Launch Date and otherwise prior to the Protocol Effective Date.

The Protocol contains a series of provisions addressing how an investment/asset manager or other agent can adhere to the Protocol on behalf of its clients. Such adherence by an agent can be on behalf of all or some of its principals.

Having adhered to the Protocol, it is possible for a party to revoke such adherence following the Protocol Effective Date. However, such revocation has no effect on amendments already made pursuant to the Protocol prior to the designated revocation date. Revocation will only have the effect of preventing protocol covered documents entered into by the party effecting revocation and another adhering party for which the Implementation Date occurs after the effective date of revocation from being amended by the Protocol.

Will the Protocol apply to cleared transactions?

The Protocol will not apply to cleared transactions. Certain of the largest CCPs have indicated they will adopt the amended ISDA rate option definitions however which would lead to an equivalent outcome for legacy cleared portfolios with such CCPs.

STRATEGIC CONSIDERATIONS IN RESPECT OF PROTOCOL ADHERENCE

A transition from forward-looking IBORs available in multiple tenors (e.g. 1, 3, 6 months) to fallbacks based on compounded overnight rates is by its nature a complex and involved process. Unlike the IBORs, such adjusted risk-free rates will not be known until the end of the relevant calculation period and will require term adjustments and spread adjustments. Moreover, the actual transition to these fallbacks may occur at different times for different IBOR benchmarks (and even for different tenors of a particular IBOR benchmark).

Extensive inventory and due diligence exercise

In terms of the Protocol, the broad scope of the amendments made by it, the range of agreements it covers and the availability of a series of bilateral Protocol amendment agreements and templates which can be used to tailor the terms of adherence requires parties contemplating adherence to undertake significant due diligence and analysis to determine in advance the impact (economic, hedging, accounting, contractual, legal and regulatory) of adherence.

It will be necessary to inventory and due diligence what may be large portfolios of trades with multiple counterparties. The due diligence will need to include identification of the current fallbacks, whether standard or bespoke; the extent to which they would work in the event of a permanent IBOR cessation; and how the existing fallbacks as well as the fallbacks introduced by the Protocol would impact on the economics of the relevant transaction.

It will also be necessary to establish whether any amendments to existing fallbacks would require a third-party consent, for example in respect of guarantees or in respect of the amendment of hedging documentation for syndicated loans. The consequences of any failure to obtain such relevant consents should also be determined. The inventory and due diligence undertaken will in addition need to address whether it will be necessary to reconfirm or retake any security and whether there are any other formalities which will need to be satisfied.

In respect of derivatives linked to another product, the due diligence will need to address any possible mismatches which could arise between the new fallbacks for the derivative and the fallbacks in the related loan, bond or structured product. This will particularly be the case where the derivative is designed to hedge those products in order to ensure that any hedge continues to function as intended after the cessation of an IBOR.

A key issue to be considered will be any potential value transfer which will arise as a result of a move to the RFR-based fallbacks and how this should be managed with counterparties and clients. ISDA's Scott O'Malia noted in May 2019 that the adjusted risk-free rate will not match the relevant IBOR exactly and that there will be winners and losers. At the time of moving to a RFR-based fallback, it is likely to be the case that the current spread between the relevant IBOR and the relevant fallback RFR (e.g. GBP LIBOR/SONIA) will be higher or lower than the spread adjustment determined using the historic five-year median. This potentially exposes parties to the risk of an increase in the amount of a payment which they will need to make or a decrease in a payment that they will receive. As a consequence, parties may wish to engage in discussions about compensatory payments for any value transfer arising from adherence to the Protocol.

Bilateral negotiations with counterparties

Having progressed the required due diligence, a party may need to invest considerable time and effort in bilateral negotiations, addressing issues such as the suitability of the changes introduced by the Protocol and whether they need to be amended in respect of a particular transaction type or a particular counterparty and its documentation. Such negotiations may also need to address any potential value transfer involved in moving to replacement fallbacks.

One method to tailor the scope of the Protocol is to use the bilateral amendment agreements and templates published by ISDA in connection with the Supplement and Protocol. Template bilateral amendment agreements allow parties to apply the terms of the Protocol to documents without the need to adhere to the Protocol itself; to exclude documents from the scope of the Protocol; to include additional documents; and to disapply the pre-cessation provisions. It is also possible to include wording to provide that the relevant fallbacks should match those in hedged products such as bonds or loans.

However parties may also need to consider the option of bilateral arrangements and more bespoke agreements beyond the Protocol amendment agreements and templates.

Another option parties may adopt in bilateral negotiations, whether as an alternative option or as a complementary approach, is to reduce IBOR exposure in legacy portfolios prior to any IBOR cessation. Options to reduce IBOR exposure include: closing-out at the transaction or portfolio level and entering into new transactions; novations; and compression exercises which serve to reduce exposure to IBORs and increase exposure to RFRs.

Consideration of such alternative options highlights the key point that parties will need to think beyond merely including RFR fallbacks into the terms of their transactions and to be aware of the risks of relying on the inclusion of such fallbacks as the sole means of transition away from IBORs.

CONCLUSION

The ISDA Fallbacks Protocol and Supplement will be released on 23 October 2020. It is already open to parties to adhere to the Protocol in escrow. For those who have not yet adhered, the scope of the amendments made and the range of agreements covered by the Protocol mean that there are a series of complicated assessments and decisions to be made. Extensive due diligence will need to be undertaken as well as an analysis to determine the potential impacts - economic, accounting, contractual, legal and regulatory - of adhering to the Protocol.

The effective date of the Protocol is only a little over 3 months away and there have already been clear indications from key regulators that parties not only should adhere to the Protocol but should do so prior to the Protocol Effective Date. Therefore only limited time is available for parties facing the major challenges and decisions which need to be addressed in relation to Protocol adherence.

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