ISDA Safe, Efficient Markets

The Wheatley Review
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

7 Sept 2012

Response from the International Swaps and Derivatives Association Inc. ("ISDA") to the Wheatley Review of Libor initial discussion paper.

Dear Sirs,

ISDA represents a broad global range of over 800 OTC derivatives market participants including corporations, pension funds, insurance institutions, asset managers and other investment companies, energy and commodities firms, clearing houses, government and supranational entities, as well as global and regional banks, and is very pleased to have the opportunity to respond to the discussion paper. Since the inception of OTC derivatives in the 1980s, its members have referenced Libor rates as the floating rate in the majority of their interest rate transactions. ISDA views itself and its membership as being a user of the rate, as published.

We are keenly interested in the integrity of Libor, but ISDA does not have any direct responsibility for the governance, management, constitution or methodology of Libor. As such, we will not be answering in any detail the Review's questions which pertain to matters such as these. Equally, we will not address considerations of possible alternatives or successors to Libor (either generically or specifically) in the case that the ultimate decision is reached that Libor should be discontinued. Our responses to selected questions where ISDA does have a comment can be found in full in the accompanying Appendix.

Overall, ISDA believes that economically Libor continues to be hugely relevant to, and necessary for the proper functioning of, the OTC derivatives market. Total notional swap outstandings that reference a Libor rate are estimated to be $300Tn, replacing Libor as a reference rate for these swaps would be a very significant undertaking.

ISDA fully recognises the importance of "reforming" Libor in terms of its governance and transparency of process and data etc, but certainly does not support its discontinuation. We are encouraged that the authorities recognise that they may well have a role to play in encouraging firms to continue contributing to Libor in a climate where perceived cost and risk concerns may be disincentivising future participation. This may become an important role for the authorities over the short to medium term. Any disruption to the Libor process could result in market turmoil of systemic proportions.

International Swaps and Derivatives Association, Inc.
360 Madison Avenue, 16th Floor
New York, NY 10017
P 212 901 6000 **F** 212 901 6001
www.isda.org

NEW YORK WASHINGTON
LONDON BRUSSELS
HONG KONG SINGAPORE
TOKYO

We have pleasure in submitting our response, and look forward to staying very much engaged with members of the review team as its work moves forward towards conclusion.

Yours faithfully,

Robert Pickel
Chief Executive Officer

International Swaps and Derivatives Association, Inc.
360 Madison Avenue, 16th Floor
New York, NY 10017
P 212 901 6000 **F** 212 901 6001
www.isda.org

NEW YORK WASHINGTON
LONDON BRUSSELS
HONG KONG SINGAPORE
TOKYO

Appendix – Responses to selected Consultation questions, in italics.

Chapter 2: Issues and failings with LIBOR

Do you agree with our analysis of the issues and failings of LIBOR?

Chapter 3: Strengthening LIBOR

Can LIBOR be strengthened in such a way that it can remain a credible benchmark?

Could a hybrid methodology for calculating LIBOR work effectively?

At a high level with regard to methodology, we generally support the use of actual trade data (where available) in Libor's compilation (which was always the case before interbank lending volumes fell away during and after the financial crisis). At the same time, we acknowledge that it will likely still be necessary to deploy algorithms or expert judgement to fill the gaps where no trade data exists. In fact, we would argue that expert judgment still plays a part even where actual trade data exists, given that the decision to transact the trade(s) depends upon the exercise of such expert judgement. Clearly work needs to be done to enhance the governance and transparency of Libor, but perhaps little more beyond that. Of note is that we have not heard from any sections of our membership that they believe that Libor should be re-engineered.

Could the number of maturities and currencies currently covered by the LIBOR benchmark be reduced?

We offer no opinion as to the appropriateness or desirability of reducing the number of Libor tenors and / or currencies but would draw attention to our comments below in respect of the likely impact of the package of changes to tenors and currencies that we believe to have been tentatively agreed.

Is an alternative governance body for LIBOR required in the short term?

Should the setting of and/or the submission to LIBOR be regulated activities?

Should the regulator be provided with specific powers of criminal investigation and prosecution in relation to attempted manipulation and manipulation of LIBOR?

What role should authorities play in reforming the mechanism and governance of LIBOR?

ISDA® Safe, Efficient Markets

Which types of financial contract, if any, would be particularly affected by the risks of a transition from LIBOR?

As the trade association for OTC derivative products, our comments below relate solely to those products, whilst recognising that changes to Libor or a transition away from it will also impact other products in other markets which often underlie OTC derivatives transactions. Within the OTC derivatives markets, interest rate derivatives are the most heavily impacted asset class. We offer some detailed analysis of how trades might be affected by changes to or a move from Libor, according to the terms of their ISDA documentation and in the wider context of incident legal risk.

The majority of OTC interest derivatives transactions use Libor rates as the reference rate for floating legs of transactions. These transactions are typically documented under an ISDA Master Agreement and a trade Confirmation, which will reference the relevant published ISDA Definitions. The Definitions give formal and detailed descriptions for all of a transaction's variables that will be referenced in the trade Confirmation. In other words, the Definitions remove the need to restate the often lengthy descriptions of commonly-used trade attributes in Confirmations. This has an important risk reducing effect in that it enables rapid (often electronic) turnaround times, given that the Confirmations can be brief in that they refer to, rather than restate the Definitions. The main operative booklet of definitions with respect to Libor is the "2006 ISDA Definitions". In essence the definitions of Libor rates are very much page-driven, by which we mean that the rate for (say) GBP Libor is defined as being the rate that appears on Reuters screen LIBOR01 (or an equivalent page in the case of the Bloomberg definition). Defining the rates in this way means that the Definition should be able to accommodate a certain amount of change to the rate in terms of methodology of compilation, for instance, so long as the rate still appears on the given page. Clearly, however, there are limits to this and as changes become more economically significant, and to the extent that Libor is fundamentally changed into something else (even if its description does not change and even if it continues to fall within the strict wording of the definition), so the risk increases that parties may claim, under doctrines of frustration or otherwise, that the contract is not what they bargained for. (see below). The definition provides that where the rate is not published at all, parties will revert to the polling of specified numbers of so-called "Reference Banks" to arrive at a rate themselves.

In respect of the large "back book" of transactions, we offer now a description of how these definitions would "cope with" changes to scope or method Libor or to its disappearance. In practice the effects of any changes would be in proportion to the significance of such changes. We understand that the BBA had, prior to recent events, long been considering changes to Libor that would have included the deletion of certain currencies and tenors. We believe these changes were on the point of being put out to public consultation. As to the currencies, the discontinuation (over time) of the AUD, CAD, DKK, NZD and SEK Libor rates has been and continues to be proposed. Of these 5 currencies, ISDA only published definitions for the AUD and CAD rates. Parties using any of the other 3 rates will presumably have had to define these rates in their own bespoke documentation and would need to act in accordance with its terms in the event of discontinuation. That said, we would suspect that trade volumes here would be very low. With respect to AUD and CAD, data from the DTCC Global Trade Repository indicates there is only a handful of extant trades, meaning that the Reference Banks fall-back should work effectively ie that firms should be able to conduct polls, albeit manually, in order to calculate a rate.

Regarding Libor's tenors, uncertainty persists as to the future of the 12 and 6 month tenors. It should be noted that many hundreds of thousands of Libor-referencing trades, perhaps in excess of 40% of the entire Libor-referencing trade population, use the 6 month tenor. If the 6 month tenor were to be stopped, or indeed Libor were to be totally discontinued significant levels of market disruption would be introduced, given that the Reference Banks mechanism would come under strain and may not be workable in practice. This is because of the sheer number of Reference Bank polls which would need to be conducted. The party responsible for conducting the poll in respect of an affected trade is the Calculation Agent (as defined in the 2006 Definitions) and specified in the trade Confirmation. Typically in customer trades, the bank party would be the nominated Calculation Agent, however in interbank trades often provision is made for co-Calculation Agents. On any given day the Calculation Agent(s) in respect of every trade resetting against an affected Libor rate will need to conduct a poll in respect of that rate. An initial obstacle here in the interbank market will be that the parties will need to agree upon which Reference Banks to approach. Once agreed, polling can take place, however it is possible that strictly speaking thousands of polls may need to be conducted on a trade by trade basis and it is highly unlikely the market could support this burden of activity. Even if all the polls were conducted in a timely and orderly manner, each would yield a different result. This would mean that a party with (say) 2 GBP Libor resetting trades with 2 banks would see those trades reset at different levels.

Changes would be required to the standard ISDA documentation to give effect to changes, once their details were known, or to address the consequences of the outright discontinuation of Libor, both in respect of the "back book" of legacy trades and to cover new trades on a going forward basis. The market would need to migrate to a successor rate or rates (pre-existing or otherwise) in respect of each Libor rate that was discontinued, be that a more minor rate such as AUD or a major one such as GBP. ISDA could publish Supplements to its Definitions to facilitate changes to contracts necessary to reference any newly-published successor rates. To facilitate the use of successors in legacy trades, ISDA would likely publish a Protocol which would have the effect of amending OTC derivatives contracts between adhering parties so as to convert their back book trades to reference the agreed successors. It would be absolutely vital to have clear and long term transition arrangements in place, given that the market will take time to migrate liquidity to new rates. It is important to note that adherence to an ISDA Protocol is entirely voluntary, and market participants will only adhere if they perceive that it is in their interest to do so. For the Protocol to be as effective as possible a significant period of time is required so that as many market participants as possible can participate, and can have the opportunity to do so as they see liquidity migrating to the new rate sources. Without such transition arrangements, the ensuing market disruption could be potentially unmanageable. Again, we are pleased that the discussion paper acknowledges the need for any transition to be carefully planned and managed.

We have mentioned the risk of claims of contractual frustration a number of times, and now turn to cover this in more detail in the context of OTC derivatives portfolios covered by English law-governed ISDA Master Agreements. As suggested above, there is likely to be something of a continuum from minor changes that could most likely still be regarded as falling within the existing definitions of the floating rates, through to more significant changes that could lead some market participants to claim under doctrines of contractual frustration or otherwise, that the nature of their contract had changed

International Swaps and Derivatives Association, Inc.
360 Madison Avenue, 16th Floor
New York, NY 10017
P 212 901 6000 **F** 212 901 6001
www.isda.org

NEW YORK WASHINGTON
LONDON BRUSSELS
HONG KONG SINGAPORE
TOKYO

fundamentally from what they had originally intended. It is certainly unclear at which point one becomes the other, and we hope that changes could be managed in such a way that it is not tested. Under the English law doctrine of frustration a contract may be discharged if broadly speaking, after its formation supervening events occur which have the effect of either (i) frustrating the contract's commercial object or purpose or (ii) making its performance impossible. It is unclear whether major changes to Libor, or its discontinuation, would be grounds for a valid claim of frustration or under some other doctrine but it will be clear those changes to or discontinuation of a rate potentially brings us into this territory and indeed some of the decided cases touch on these very points. As mentioned above, the 2006 ISDA Definitions provide a fall-back to Reference Bank polling in the event that a given rate disappears from a page, so to a degree direct contractual provision has been made for the eventuality of Libor's discontinuation. On the other hand, as noted above, that fall-back might not prove workable in practice. We believe that there is a risk that discontinuation of Libor or changes other than those that are clearly economically immaterial to its calculation, could give grounds for claims of contractual frustration. We urge the authorities to bear this in mind as they contemplate the future of Libor, both in its current form or some other, in order to avoid the major market disruption that the uncertainty of any such claims would cause.

Additional analysis would be required to assess the risk of claims under doctrines such as contractual frustration (or any local equivalent) in respect of ISDA Master Agreements governed by anything other than English law. We understand that concerns similar to those noted above could arise under New York law. New York or English law is the governing law for most OTC derivatives contracts.

Chapter 4: Alternatives to LIBOR

Are there credible alternative benchmarks that could replace LIBOR's role n the financial markets?

Should an alternative benchmark fully replace LIBOR, or should it substitute for LIBOR in particular circumstances?

Should particular benchmarks be mandated for specific activities?

Over what time period could an alternative to LIBOR be introduced?

Please see our comments above as to the need for there to be clear and long term arrangements in place for the management of any transition. Failure to achieve a smooth and progressive transition will result in major market dislocation and significant "jump risk" if there is an abrupt move from Libor to a successor. The rate of any transition will likely be chiefly determined by the speed of migration to an alternative in terms of liquidity as well the extent to which market participants have amended their documentation (along the lines suggested above) to embrace such transition.

What role should authorities play in developing and promoting alternatives to LIBOR?

Chapter 5: Potential implications on other benchmarks

Are there other important markets or benchmarks that could face similar issues to those identified relating to LIBOR?

Relevant in the consideration of benchmarks more broadly, and for completeness, we offer here a brief description of ISDA's own suite of swap prices, ISDAFIX. More detailed information is available on www.ISDA.org.

- *Swap rate mid prices for 6 currencies (EUR, USD, GBP, CHF, HKD and JPY) with multiple tenors to 30 years published daily or twice-daily in some cases.*
- *Established in 1998 in cooperation with Thomson Reuters and ICAP.*
- *Thomson Reuters (ICAP in the case of USD) collect contributions from each currency panel. Topping and tailing is undertaken, with the remainder being averaged to give the rate.*
- *ISDAFIX is currently published on Thomson Reuters, Bloomberg and Telekurs, with individual contributions being available too.*
- *The rate is used in the professional markets, mainly for the valuation of cash-settled swaptions and early terminations.*
- *Historical data is available.*

Should there be an overarching framework for key international reference rates?