ISDA Safe, Efficient Markets

December 4, 2019

Andrew Bailey
Chief Executive Officer
UK Financial Conduct Authority

John Williams
President and Chief Executive Officer
Federal Reserve Bank of New York

Co-Chairs, Financial Stability Board Official Sector Steering Group

By email

Re: ISDA Pre-Cessation Triggers for Derivatives Fallbacks

Dear Mr. Bailey and Mr. Williams:

Thank you for your continued support of ISDA's work to implement robust fallbacks for derivatives referencing key interbank offered rates (IBORs), including in your November 13, 2019 letter. ISDA acknowledges the high priority that the Financial Stability Board Official Sector Steering Group (FSB OSSG) places on developing and implementing fallbacks for derivative contracts[1]. We also recognize the importance of both scenarios outlined by the FSB OSSG: the permanent cessation of a key IBOR, and a determination by the UK Financial Conduct Authority (FCA) that LIBOR is no longer representative of the underlying market but continues to be published. ISDA has demonstrated its commitment to these issues since 2016 by conducting multiple market-wide consultations.

ISDA remains fully focused on the timely delivery of a fallback solution to prevent the systemic disruption that could occur if LIBOR or another key IBOR ceases. As we finalize the work on permanent cessation fallbacks, we will simultaneously work with regulators and the industry to

[1] In July 2016, a letter from the then co-chairs of the FSB OSSG asked ISDA to undertake work to enhance the contractual robustness of derivatives contracts to address the risk that a key IBOR is discontinued. That letter referenced the work of the FSB OSSG Market Participants Group (MPG). Specifically, it noted that the MPG's July 2014 report concluded that "in most cases, fallback provisions are not sufficiently robust for a permanent discontinuation of a key IBOR…[w]ithout carefully considered alternatives and mitigants, claims of contract frustration could arise. In the worst case, there could be widespread valuation and accounting problems, and workout costs could be severe." The work we have done since 2016 to develop permanent cessation fallbacks for derivatives would mitigate these concerns and address the related risks

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increase market understanding of the implications of a "non-representative" LIBOR, and attempt to build a consensus on how to implement pre-cessation fallbacks, in line with the FSB OSSG's request. A recent speech from Edwin Schooling Latter of the UK FCA was helpful in clarifying certain issues, including that a "non-representativeness" determination related to LIBOR would not be reversible[2]. In order to further increase market understanding, we believe it is critical that market participants also receive further clarity on the following:

1. A statement from the UK FCA and the ICE Benchmark Administration (IBA) that the "reasonable period" during which a "non-representative" LIBOR would be published would be minimal (i.e., a number of months not years) after the FCA announces that LIBOR is no longer representative.

2. A public and definitive confirmation directly from CCPs clearing LIBOR derivatives or its regulatory supervisor that:

    - The CCP has implemented appropriate rule changes providing that upon an announcement by the FCA that LIBOR is "non-representative", the CCP will amend its entire portfolio of cleared LIBOR derivatives so these derivatives reference the relevant adjusted RFR instead; or
    - Upon an announcement by the FCA that LIBOR is "non-representative", the CCP will in fact use any discretionary powers provided by its rules to amend its entire portfolio of cleared LIBOR derivatives so these derivatives reference the relevant adjusted RFR instead[3].

Further clarity on these issues should greatly assist market participants in understanding the implications of a "non-representative" LIBOR. Related to the first point above, and in line with the positions raised by many respondents to our recent consultation on pre-cessation issues, we strongly encourage the FCA to consider whether it is appropriate for a non-representative LIBOR to be published for more than a very minimal time period. If a non-representative LIBOR continues to be published for an extended period, and therefore continues to be used in legacy cash products that cannot be amended, then market participants with exposure to those products will require derivatives based on the "non-representative" LIBOR to risk-manage their exposure, and will do so based on the facts and circumstances at the time (which would include,

[2] https://www.fca.org.uk/news/speeches/next-steps-transition-libor

[3] In our recent consultation, we cited the rulebook provisions of certain CCPs that give those CCPs discretion to change the interest rate referenced in cleared transactions or close out the transactions under certain circumstances, including if the original interest rate is no longer representative or reliable. However, these provisions do not provide *ex ante* certainty on whether or precisely when the CCPs would in fact change the interest rates, whether any change would apply to all or only a subset of existing cleared transactions, or what the new interest rate would be. Therefore, it is uncertain at this time whether the CCPs would take an action that would have the same result as a pre-cessation trigger based on "non-representativeness" (*i.e.*, falling back to an adjusted RFR for all cleared transactions immediately upon a "non-representative" determination for LIBOR in the relevant currency or currencies)

among other things, exposure to LIBOR in "non-derivatives" and liquidity of RFRs at that time).

In your November 13 letter, you asked ISDA to include a pre-cessation fallback trigger alongside permanent cessation triggers as standard language in the definitions for new derivatives, and in a single protocol without embedded optionality for outstanding derivatives transactions. As referenced in your November 13 letter, responses to our consultation on pre-cessation issues earlier this year indicated that a majority of market participants would generally not want to continue referencing LIBOR in existing or new derivatives contracts following a statement from the UK FCA that LIBOR is no longer representative of its underlying market. However, the consultation did not reveal a consensus on how to respond to such a statement in the context of fallbacks for derivatives contracts[4]. In fact, less than half of the respondents to the recent consultation supported the strategy described in your November 13 letter. Additionally, more than a quarter of respondents opposed any use of a pre-cessation trigger for derivatives fallbacks.

We understand the importance the FSB OSSG places on issues related to a "non-representative" LIBOR, and the potential impact that such a rate could have on existing derivatives contracts and market fragmentation. The ISDA Board shares this view. In light of the feedback received in our pre-cessation consultation, the strategy described in your November 13 letter would require ISDA to re-consult with the market on a single documentation approach and engage with relevant competition authorities. We are prepared to do so once the market has the benefit of appropriate clarity on the issues described above.

If a strong majority of market participants supports a "non-representativeness" pre-cessation fallback trigger for LIBOR derivatives in response to this consultation, then we would work to implement pre-cessation fallbacks – either along with the documentation for permanent cessation fallbacks described below, or as a second step to complement the permanent cessation fallbacks[5]. In any event, we will offer standard language for a "non-representativeness" pre-cessation fallback trigger that market participants could use – for example, in derivatives that hedge cash products with a pre-cessation fallback trigger.

We are currently on track to finalize the substantive portion of our work to develop permanent cessation fallbacks by the end of 2019, and to facilitate implementation during the first half of

[4] In October 2019, ISDA published a report summarizing the responses to the consultation. *Anonymized Narrative Summary of Responses to the ISDA Pre-Cessation Consultation*, available at http://assets.isda.org/media/e0b1bac2/04397355-pdf/

[5] As with our work to implement permanent cessation fallbacks in ISDA's standard documentation, we would engage with the Antitrust Division of the US Department of Justice (DoJ) and competition authorities in other relevant jurisdictions before submitting to the market any proposed changes to ISDA's standard documentation. As you know, ISDA has already advised the Antitrust Division and other competition authorities as to its plans regarding implementation of permanent cessation fallbacks and the status of discussions and feedback from market participants regarding pre-cessation fallbacks. ISDA has requested a Business Review Letter request from the DoJ with respect to permanent cessation fallbacks and expects to continue discussions with the DoJ and competition authorities in other relevant jurisdictions regarding all aspects of its work in this space

2020. On November 15, 2019, we released the results of a third successful industry consultation on the adjustment methodologies for permanent cessation fallbacks rates. Based on strong majorities, this concluded that the adjustments should use a compounded setting in arrears rate with a spread adjustment calculated as the median of the historical differences between the IBOR and the corresponding RFR over a five-year lookback period. Bloomberg expects to commence publication of indicative fallback rates based on these adjustments at the beginning of 2020.

We will shortly issue a brief supplemental consultation to confirm the suitability of these adjustments for fallbacks in derivatives referencing euro LIBOR and EURIBOR. Upon completion of this consultation in the first quarter of 2020, we will publish the Supplement to the 2006 ISDA Definitions containing the fallbacks and will open for adherence a protocol to include these fallbacks in existing derivatives. The amendments to new and existing derivatives contracts will take effect approximately three months later, in the second quarter of 2020. Based on feedback and support from market participants, we believe that the new documentation will provide a critical backstop in contracts that continue to reference LIBOR or another key IBOR if and when that IBOR ceases.

We look forward to continuing to work with you and the other representatives of the FSB OSSG. Please do not hesitate to reach out if you have any questions.

Sincerely,

Scott O'Malia
Chief Executive Officer

Katherine Tew Darras
General Counsel