ISDA Safe, Efficient Markets

2020 Consultation on How to Implement Pre-Cessation Fallbacks in Derivatives

Given additional information in the market since ISDA's 2019 consultation on pre-cessation issues for LIBOR derivatives, ISDA is consulting again on whether to add a pre-cessation trigger ('pre-cessation fallback provisions') to the permanent cessation fallbacks that it is implementing for LIBOR in its standard documentation.[1]

Responses are due March 25, 2020. This deadline will not be extended.

Background

Pre-Cessation Fallback Provisions

In a March 2019 letter to ISDA, the Financial Stability Board Official Sector Steering Group (FSB OSSG) co-chairs asked that ISDA consult on determining the need for a potential pre-cessation trigger for fallbacks that would take effect if the UK Financial Conduct Authority (UK FCA) found that LIBOR 'is no longer capable of being representative' or is 'non-representative'. In response to this request, ISDA issued a consultation on May 16, 2019, which is available at: https://www.isda.org/a/md6ME/FINAL-Pre-cessation-issues-Consultation.pdf.

A majority of respondents to ISDA's May 2019 consultation on pre-cessation issues stated that generally they would not want to continue referencing LIBOR in derivatives contracts following a public statement by the UK FCA that LIBOR was no longer representative. However, the respondents expressed a wide variety of views regarding whether and how to implement a pre-cessation fallback trigger related to non-representativeness in derivatives. A report summarizing the results of the consultation is available at: https://www.isda.org/a/kkaTE/2019.10.21-Anonymized-Pre-Cessation-Consultation-Report.pdf.

In November 2019, the FSB OSSG sent ISDA a letter requesting that ISDA include a pre-cessation trigger alongside the permanent cessation triggers as standard language in the fallbacks ISDA intends to implement in the 2006 ISDA Definitions and in the 'Protocol' for inclusion of the amended definitions (*i.e.*, the definitions with the updated fallbacks) in legacy contracts. A copy of the FSB OSSG's letter is available at: https://www.fsb.org/wp-content/uploads/P191119.pdf.

In December 2019, ISDA responded to the FSB OSSG indicating that it would continue with finalization of permanent cessation fallbacks while simultaneously working with regulators and the industry to increase market understanding of the implications of a 'non-representative' LIBOR, and attempting to build consensus on how to implement fallbacks following the occurrence of a pre-cessation trigger. In its letter, ISDA indicated that it was critical for market participants to receive further clarity from: (1) the UK FCA and ICE Benchmark Administration (IBA) regarding the "reasonable period" during which a 'non-representative' LIBOR would be published; and (2) central counterparties (CCPs) regarding the specific actions they would take if

[1] The fallbacks that ISDA is implementing will apply to LIBOR and other IBORs but the scope of this consultation is limited to LIBOR.

LIBOR were found to be 'non-representative'. A copy of ISDA's letter is available at https://www.isda.org/a/IwcTE/December-2019-Letter-to-the-FSB-OSSG-FINAL.pdf.

Since ISDA's December 2019 letter, the market has received several pieces of additional information in response to ISDA's request. These include:

- LCH, CME, Eurex and ICE commented on ISDA's letter at the US Commodity Futures Trading Commission's Market Risk Advisory Committee December 2019 meeting. A recording of that meeting is available at: https://www.youtube.com/watch?v=kGHr_NSTyUM&feature=youtu.be. The CCP statements begin around 2 hours 17 minutes into the recording.
- LCH launched a consultation on rulebook changes to implement fallbacks following the occurrence of a pre-cessation trigger. The consultation remains open until March 23, 2020 and is available at: https://www.lch.com/membership/ltd-membership/ltd-member-updates/lch-limited-rule-change-committee-10-january-2020.
- The UK FCA sent a letter to ISDA providing additional information to the market on a 'non-representative' LIBOR scenario. The letter is available at: https://www.isda.org/a/E1LTE/FCA-letter-to-ISDA-on-Non-representative-LIBOR-January-2020.pdf.
- IBA sent a letter to ISDA explaining how it would respond to a determination by the UK FCA that LIBOR is no longer representative. The letter is available at: https://www.isda.org/a/M1LTE/IBA-Letter-to-ISDA.pdf.

Implementation of Fallbacks in ISDA Documentation

As it has done from time to time, ISDA intends to amend the 2006 ISDA Definitions by publishing a 'Supplement' to the 2006 ISDA Definitions. The Supplement will implement the fallbacks by amending and restating the relevant 'Rate Options' for LIBOR in each currency in which it is published (USD, GBP, CHF, JPY, EUR) and the other IBORs[2] for which ISDA is implementing fallbacks. Upon publication of the Supplement, *all* transactions incorporating the 2006 ISDA Definitions that are entered into on or after the effective date of the Supplement (*i.e.*, the date on which the 2006 ISDA Definitions are amended) will include the amended terms (*i.e.*, the relevant 'Rate Option' with the updated fallback provisions).

Transactions entered into prior to the effective date of the Supplement (so called 'legacy derivative contracts') will continue to be based on the 2006 ISDA Definitions as the 2006 ISDA Definitions existed at the time of trading (*i.e.*, before they were amended pursuant to the Supplement), and therefore will not include the updated fallback provisions. However, ISDA also intends to publish a Protocol to facilitate multilateral amendments to incorporate the amended terms, and therefore the fallback provisions, in legacy derivative contracts. By adhering to the Protocol, market participants would agree that *all* of their legacy derivative contracts *with all other adherents* will include the amended terms, and will therefore include the

[2] These include EURIBOR, TIBOR, Euroyen TIBOR, BBSW, HIBOR and CDOR. ISDA is also implementing fallbacks for SOR to an 'Adjusted SOR' that will be published by ABS Co., the current administrator for SOR.

same fallback provisions that will be included in transactions entered into after the effective date of the Supplement (and therefore incorporate the amended 2006 ISDA Definitions), except to the extent that two adherents separately bilaterally negotiate different terms. As always, adherence to any such Protocol will be voluntary and will only amend contracts between two adhering parties (*i.e.*, it will not amend contracts between an adhering party and a non-adhering party or between two non-adhering parties).

Adjustments to Fallback Rates

LIBOR and the other IBORs for which ISDA is implementing fallbacks are published in various tenors and incorporate bank credit risk premia and a variety of other factors. The fallback rates are, however, overnight rates that are risk-free or nearly-risk free. To account for these differences in the event that the fallback provisions apply (whether as the result of a 'non-representativeness' determination or permanent cessation), each overnight rate will be subject to two adjustments. First, the overnight rate will be compounded in arrears over the tenor of the relevant IBOR (e.g., 1 month, 3 month). Then, a spread adjustment will be added to the compounded rate. For LIBOR, the spread adjustment will be calculated based on the median of the historical differences between LIBOR in the relevant currency for the relevant tenor and the corresponding fallback rate compounded over a time period with the same length as the tenor, over a five-year period prior to the announcement triggering the fallbacks.

Additional information about the fallback rates, including the adjustments that would apply to the rates, is available at https://www.isda.org/2020/01/10/benchmark-fallback-consultations/.

Question

Please note that ISDA has provided specific criteria below so that respondents understand how ISDA will use consultation responses to determine how to implement pre-cessation fallback provisions for LIBOR in the Supplement to the 2006 ISDA Definitions and related Protocol.

Respondents should review all of the information above and the linked documents, in addition to whatever other information they deem relevant, in formulating their answer to the question below.

By participating in this consultation, you agree not to use this process for any anticompetitive purpose, and further agree and warrant that you will not engage in any conduct that would cause any other party participating in this consultation to be in violation of any competition or antitrust law or regulation. ISDA has taken and will continue to take safeguards and protections to ensure that the use of the results of this consultation comply with applicable laws and regulations.

Should ISDA publish a Supplement to the 2006 ISDA Definitions so that the Rate Options for LIBOR in the relevant currencies (USD, GBP, CHF, JPY, EUR) all contain fallbacks that would apply upon the first to occur of (i) a permanent cessation trigger or (ii) a 'non-representativeness' pre-cessation trigger, and publish a Protocol to allow adherents to include the amended definitions (i.e., the definitions with the combined permanent cessation and pre-cessation fallback provisions) in all of their legacy contracts with other adherents?

In this scenario, the spread adjustment would be calculated as of the relevant announcement date regarding either 'non-representativeness' (i.e., the date that the UK FCA states that LIBOR 'is no longer capable of being representative') or 'permanent cessation', as applicable, but the fallback rates would not apply until the date on which that LIBOR is 'non-representative' (based on the statement by the UK FCA) or is discontinued, as applicable (if such date is different from the announcement date). If an announcement that LIBOR 'is no longer capable of being representative' occurs prior to an announcement regarding 'permanent cessation' or the occurrence of permanent cessation, then the 'non-representativeness' spread would be the only spread applicable for derivatives that use the fallbacks in the standard ISDA Definitions and related Protocol (*i.e.*, the spread for these derivatives would not subsequently be adjusted to account for a permanent cessation announcement or occurrence).

Market participants who do not want these combined pre-cessation and permanent cessation fallback provisions would need to bilaterally negotiate terms outside of the standard ISDA Definitions and related Protocol.[3]

Yes ○

No ○

If you selected "No", please indicate whether you would be unavoidably harmed by, and/or unable to use, a Supplement and Protocol that implement pre-cessation fallback provisions in the manner described in the question above.

We welcome additional explanation for your response but you are not required to provide any.

Respondent Name (will not be disclosed):____

Respondent Country:____

Respondent Type (please select one):

[3] ISDA could publish a variety of templates for standard modifications.

Bank/broker-dealer ○

Market infrastructure (e.g., central counterparty) ○

Asset manager ○

Energy/commodity firm ○

Hedge fund ○

Insurance company ○

Local or regional government entity, supranational or government sponsored entity ○

Pension fund ○

Other end user (e.g., corporate) ○

Professional services firm or trade association ○

Respondent jurisdictions and types will be used for determining whether the consultation is successful, as explained below, and will be published on an anonymized and aggregated basis.

Responses are due March 25, 2020. This deadline will not be extended. Please email your response to FallbackConsult@isda.org and clearly indicate that you are submitting a response in the subject line of your email. For your convenience, you can use this form for your responses (but you are not required to do so).

ISDA will hold a webinar and Q&A session for market participants on March 4, 2020 at 2:00 pm London time. The webinar will be recorded and posted on the public portion of the ISDA website. Additional information will be forthcoming.

Respondents can submit questions to FallbackConsult@isda.org.

Criteria and Ramifications

If the criteria set forth below are satisfied, ISDA intends to publish the Supplement and Protocol described in the question above. Counterparties that do not want to use this approach would need to bilaterally negotiate terms outside of the standard ISDA Definitions and related Protocol.[4]

- At least 70 market participants (which do not include professional services firms or trade associations[5]) submit responses. Any responses that do not clearly indicate "Yes" or "No" will not be counted in this number. Affiliated entities will be counted as one market participant for purposes of this count and for calculating the percentages below.

[4] ISDA could publish a variety of templates for standard modifications.
[5] Members of trade associations should submit their own responses to this consultation.

- At least 35% of responses are from market participants *other than* bank/broker-dealers and infrastructure providers.
- **At least 65% of respondents select "Yes" and at least 35% of those who select "Yes" are not bank/broker-dealers or infrastructure providers.**
- Respondents who select "No" *and* indicate that they would be unavoidably harmed by, and/or unable to use, such a Supplement and Protocol do not represent a significant portion of a particular segment of the market (e.g., all insurance companies who respond, all corporates who respond).

If the criteria set forth above are not satisfied, ISDA intends to publish:

- the Supplement and Protocol to implement the permanent cessation fallbacks;
- amendments to the 2006 ISDA Definitions (as part of the Supplement) to allow market participants to incorporate pre-cessation fallback provisions in their new derivatives (in addition to the permanent cessation fallbacks) if they choose to do so; and
- an "Annex" to the Protocol to allow market participants to "opt-in" to the pre-cessation fallback provisions with counterparties who also opt-in to those fallback provisions as part of their adherence to the Protocol implementing the permanent cessation fallbacks. Again, bilateral solutions would also remain an option.

ISDA hopes to publish the results of this consultation and information regarding next steps for implementing derivatives fallbacks in late April or early May.