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Benchmark Reform: ISDA launches IBOR Fallbacks Supplement

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With the planned discontinuation of LIBOR at the end of 2021 fast-approaching, it is *"impossible to overstate the significance of fallbacks"* [1]. Market participants may have exposure to LIBOR at the time that it is discontinued and, to address that risk, ISDA has continually highlighted the importance of using alternative risk-free rate (**"RFRs"**) for both LIBOR and the other main interbank offered rates (**"IBORs"**). As part of its promotion of the use of contractual fallback provisions to mitigate the risks arising from IBOR discontinuance, ISDA launched an IBOR Fallbacks Supplement, an IBOR Fallbacks Protocol and a related FAQ on 23 October 2020.

THE SUPPLEMENT

The IBOR Fallbacks Supplement (the **"Supplement"**) amends the 2006 ISDA Definitions to include new contractual fallbacks for floating rate options that link to certain IBORs.

The Supplement will only affect new derivatives contracts entered into from 25 January 2021 onwards.

The Supplement envisages the continued use the following IBORs until the occurrence of certain specified trigger events: GBP LIBOR; CHF LIBOR; USD LIBOR; EUR LIBOR; EURIBOR; JPY LIBOR; TIBOR; Euroyen TIBOR; Australian BBSW; Canadian CDOR; Hong Kong HIBOR; Singapore SOR; and Thai THBFIX.

Trigger Events

Where a trigger event occurs in respect of an IBOR, the contract will default to the use of an adjusted version of the relevant RFR as the replacement rate. These triggers (known as **"Index Cessation Events"**) are:

- the permanent cessation of the relevant IBOR;
- the administrator of the relevant IBOR ceasing to provide that IBOR (permanently or indefinitely) where no successor administrator has been found; or
- (in the case of LIBOR rates only), a public statement or publication from the UK Financial Conduct Authority (the **"FCA"**) (as the regulatory supervisor of ICE Benchmark Administration (**"IBA"**, which administers LIBOR)) announcing that:
  - the relevant LIBOR rate is not (or as of a specified future date will no longer be) representative of the underlying market and economic reality that it is intended to measure, and that such representativeness will not be restored; and
  - the FCA is aware that this announcement will trigger in-scope contractual fallbacks activated by pre-cessation announcements.

What RFR will be used?

The RFR used in respect of an IBOR will depend on the relevant currency. For example, the RFR for GBP LIBOR will be the Sterling Overnight Index Average (**"SONIA"**), while the RFR for USD LIBOR will be the Secured Overnight Financing Rate (**"SOFR"**). The RFRs will be calculated and published by Bloomberg, which has been doing so since 21 July 2020.

THE PROTOCOL

As mentioned above, the Supplement is designed only for new derivatives contracts entered into from 25 January 2021 onwards.

What about legacy derivatives contracts?

ISDA's IBOR Fallbacks Protocol (the **"Protocol"**) is ISDA's way of addressing the widespread use of IBORs in existing derivatives contracts. Adhering to the Protocol will give parties to legacy derivatives contracts a straightforward

[1] ISDA Chief Executive Officer, Scott O'Malia: derivatiViews, 'A Major Milestone for Benchmark Reform', 26 October 2020.

way to update those contracts to include the appropriate contractual fallback provisions. The fallbacks in the Protocol are the same as those in the Supplement.

Adhering to the Protocol will allow parties to multilaterally amend contracts, in circumstances where the other parties to the contracts have also adhered to the Protocol.

The Protocol applies only to **"Protocol Covered Documents"**, which includes in-scope ISDA master agreements, credit support documents and confirmations. Notably, it also covers certain non-ISDA master agreements and additional credit support documents, a full list of which is contained in the Additional Documents Annex to the Protocol. The Protocol will not apply to documents governing cleared transactions.

For all Protocol Covered Documents, the Protocol covers the use of each of the 2006 ISDA Definitions, the 2000 ISDA Definitions, the 1998 ISDA Euro Definitions, the 1998 Supplement to the 1991 ISDA Definitions and the 1991 ISDA Definitions (each a **"Covered ISDA Definitions Booklet"**). However, the Protocol not only applies to contracts that incorporate one of the Covered ISDA Definitions Booklets: it also covers contracts that reference a relevant IBOR as having the meaning given to it in a Covered ISDA Definitions Booklet, and to contracts that reference a relevant IBOR (howsoever defined).

Adherence is open to both ISDA members and non-members and is done by way of signing an adherence letter and uploading it to the ISDA website. There is a one-time fee of US$500 for ISDA Primary Members to adhere to the Protocol. This one-time fee will also apply to non-ISDA Primary Members who wish to adhere to the Protocol, however the fee will be waived where the non-ISDA Primary Member adheres before the effective date of the Protocol (25 January 2021).

What if the Protocol cannot be used?

In a transaction where only some or none of the parties have adhered to the Protocol, the Protocol (and resulting amended definitions) will not apply and parties will continue to be bound by the definitions in existence at the time the transaction was entered into. As is customary in ISDA protocols, the Protocol will also not apply to any agreement in which the parties expressly exclude its application.

As an alternative to the Protocol, parties may wish to consider amending contracts on a bilateral basis. ISDA has published template documentation to allow parties to do this. These documents allow the scope of the Protocol to be tailored to the specific needs of parties. ISDA have also prepared descriptive outlines of the bilateral documents.

MINIMISING MISMATCH FOR LOAN-LINKED INTEREST RATE SWAPS

LMA adds new Screen Rate Replacement Event

The Loan Market Association ("**LMA**") responded to the Protocol by adding a new paragraph to its *'Replacement of Screen Rate'* clause.

This new paragraph provides for a further, optional, **"Screen Rate Replacement Event"** which would be triggered by a regulatory supervisor making a *"pre-cessation announcement"* in relation to the relevant IBOR. As mentioned above, one of the Index Cessation Events set out in the Supplement (in respect of LIBOR rates only) is a publication or statement from the FCA (as the regulatory supervisor of the IBA (which administers LIBOR)) to the effect that:

(a) the relevant LIBOR rate is not (or as of a specified future date will no longer be) representative of the underlying market and economic reality that it is intended to measure, and that such representativeness will not be restored; and

(b) the FCA is aware intends that this announcement will trigger in-scope contractual fallbacks activated by pre-cessation announcements.

Where a pre-cessation announcement satisfies the requirement at (a) (it may also satisfy the requirement at (b), but that is optional for the purposes of the LMA's additional Screen Rate Replacement Event), it would trigger contractual fallbacks (such as those set out in the Protocol).

Why did the LMA take this step?

The LMA action was aimed at minimising the scope for a mismatch where *'loan-linked'* ISDA interest rate swaps automatically switch over to, for example, SONIA (rather than GBP LIBOR) while the underlying facilities agreement continues to reference GBP LIBOR (because a Screen Rate Replacement Event has not occurred).

From the LMA's perspective, this issue would only (for the time being) be relevant to LIBOR-based interest rates (i.e. for GBP and USD loans). However, the Working Group on Euro Risk Free Rates may also announce a *'non-representativeness pre-cessation trigger'* for use with EURIBOR later this year – and the revised LMA wording could be used to apply to EURIBOR and other IBORs as well as LIBOR.

The LMA noted that the use of its Replacement of Screen Rate clause will not eliminate the scope for mismatch between loan interest rates and rates used for *'loan-linked'* interest rate swaps. This is because the LMA clause only operates as a trigger for an amendment process whereby the parties to the relevant facilities agreement can agree with [Majority Lender] consent to make amendments to replace the **"Screen Rate"** with a **"Replacement Benchmark".** This contrasts with the *'fallback'* mechanics in the ISDA documents which can automatically trigger movement to alternative RFRs without requiring a further amendment process.

WHAT'S NEXT?

For **new derivatives contracts** that incorporate the 2006 ISDA Definitions from 25 January 2021 onwards, no further action is required.

Parties to **existing derivatives contracts** should consider whether they wish to adhere to the Protocol or amend such contracts on a bilateral basis.

While there is no cut-off date for adherence to the Protocol, ISDA have reserved the right to designate a cut-off date by giving 30 days' notice. The list of adherents to is published on the ISDA website. To date, over 400 market participants have signed up, including the Bank of England.

ISDA's work continues

ISDA have stated that their work in respect of definitions is ongoing. As part of this, they are working to produce standard definitions for daily RFRs for use in new transactions, as well as developing new RFR-based swap rates which will incorporate the amended IBOR fallbacks (expected in 2021).

KEY CONTACTS

Phil Cody
Partner, Finance
Head of New York Office
+1 212 782 3290
phil.cody@arthurcox.com

Brendan Wallace
Partner
+353 1 920 1069
brendan.wallace@arthurcox.com

Matt Dunn
Partner
+353 1 920 2020
Matt.Dunn@arthurcox.com

Maedhbh Clancy
Of Counsel
+353 1 920 1225
maedhbh.clancy@arthurcox.com

Sinéad Williams
Associate
+353 1 920 1439
sinead.williams@arthurcox.com

Sinéad Cantillon
Professional Support Lawyer
+353 1 920 1083
sinead.cantillon@arthurcox.com