WILLKIE FARR & GALLAGHER LLP

CLIENT ALERT

ISDA Publishes IBOR Fallbacks Supplement and Protocol

November 16, 2020

AUTHORS

Alessandro Turina | Conrad G. Bahlke | Athena Eastwood | Alcide D. King

On October 23, 2020, the International Swaps and Derivatives Association, Inc. ("ISDA") launched and published (1) the IBOR Fallbacks Supplement (the "Supplement") to the 2006 ISDA Definitions (the "Definitions") and (2) the ISDA 2020 IBOR Fallbacks Protocol (the "Protocol"). The effective date of the Supplement and the Protocol is January 25, 2021 (the "Effective Date"). The launch and publication of the Supplement and the Protocol mark an important step in providing market participants with a tool to mitigate the risks that could emerge following the anticipated discontinuation of the London Interbank Offered Rate ("LIBOR") after December 31, 2021.

The Supplement amends ISDA's standard definitions for certain benchmark interbank offered rates ("IBORs") contained in the Definitions and adds fallback alternative risk-free rates ("RFRs") for such IBORs that are triggered upon the occurrence of certain specified cessation events. On and after the Effective Date, any new derivative transactions that incorporate the Definitions will automatically include the fallback alternative RFRs and related triggers.

The Protocol is a standardized multilateral contract amendment that allows market participants to amend existing legacy contracts that reference certain IBORs by adding fallback alternative RFRs and triggers for such IBORs that generally match the amendments made by the Supplement. On and after the Effective Date and following the decision of both parties to an existing legacy contract to adhere to the Protocol, the Protocol will automatically apply to all applicable existing legacy contracts of both adhering parties and add fallback alternative RFRs and related triggers to such legacy contracts. As an alternative to multilateral adherence to the Protocol, ISDA has provided several bilateral amendments that enable a party to bilaterally adopt the Protocol with counterparties, exclude existing documents from the scope of the Protocol, disapply the pre-cessation event trigger (discussed below) or amend the scope and terms of the Protocol with respect to certain existing legacy documents.

Background

LIBOR is a benchmark interest rate at which prime banks in London offer loans to other prime banks in London. It is produced from daily polls of participating banks for five currencies and seven maturities. LIBOR is widely used as a primary reference rate for interest rate swaps and interest rate derivatives, other derivatives, portfolio securities, loans, repurchase agreements and prime brokerage facilities. IBORs are interest rate benchmarks that are meant to reflect the cost at which large banks can borrow on a short-term, unsecured basis in the wholesale market. Similar to LIBOR, each IBOR is produced from daily dealer polls of participating banks for multiple currencies and multiple tenors. IBORs are used as reference rates in a wide variety of floating rate products (together with LIBOR), including derivatives, floating rate notes, loans, securitizations and consumer products.

In July 2014, the Financial Stability Board published a report noting that the reliance on and use of LIBOR and IBORs as benchmark rates for a number of financial products represents a "potentially serious source of vulnerability and systemic risk" in light of cases of market manipulation of LIBOR and IBOR rates by European and U.S. banks to benefit their own portfolios. The Financial Stability Board report recommended the development of "alternative, nearly risk-free rates." In July 2017, the United Kingdom's Financial Conduct Authority ("FCA") announced that it would no longer compel or encourage panel banks to submit LIBOR rates after December 31, 2021. The implications of the FCA's announcement are significant in that if LIBOR were to cease being published, under ISDA's current version of the Definitions, the calculation agent would need to determine LIBOR by conducting dealer polls. Such dealer polls could fail because major dealer banks would likely be unable and unwilling to provide quotes. To the extent that dealer banks provided quotes in such a scenario, the quotes could vary significantly among dealers. In either case, the lack of quotes and variance of quotes could lead to disputes over what the value of LIBOR should be. Similar concerns exist with respect to the discontinuation of IBOR rates.

Fallback Rates

Public/private working groups in different jurisdictions have designated rates to be used as fallback alternative RFRs to LIBOR and IBORs in their respective jurisdictions. The fallback rates include AONIA (Australian Dollar), CORRA (Canadian Dollar), SARON (Swiss Franc), €STR (Euro), SONIA (Sterling), HONIA (Hong Kong Dollar), TONA (Yen) and SOFR (U.S. Dollar). All of the designated fallback rates are compliant with the International Organization of Securities Commissions' international best practices.

There are a number of differences between IBORs and the designated fallback rates. IBORs are forward-looking rates that reflect the unsecured interbank funding market. IBORs include a term component as well as a premium for the credit risk of the unsecured lending. The fallback rates are RFRs based on the prior day's transactions and do not include a credit risk or term component. IBORs are available in multiple tenors while the fallback rates are overnight rates. Moreover, IBORs are unsecured, whereas some of the fallback rates (*e.g.*, SOFR and SARON) are secured. Because of the numerous differences between IBORs and the fallback rates, the fallback rates cannot simply replace IBORs in existing legacy contracts. The fallback rates (and/or the actual terms of the legacy contracts themselves) need to be adjusted by the parties so that legacy contracts that were originally negotiated to reference an IBOR match as closely as possible the original intent of the parties once a fallback rate takes effect.

After numerous industry consultations on adjustment methodologies, it was determined that the fallback alternative RFRs will be compounded in arrears during the applicable interest period and a spread adjustment will be added to the compounded rate.[1] The spread adjustment will be a single number that is the historic median spot spread between the applicable IBOR and the fallback RFR, over a five-year lookback period from the time of IBOR cessation. ISDA selected Bloomberg Index Services Limited to calculate and publish on a daily basis the selected spread adjustments. Publication of certain spread adjustments began in July 2020.

Supplement

The Supplement amends ISDA's standard definitions for certain benchmark IBORs contained in the Definitions and adds fallback alternative RFRs for such IBORs that are triggered upon the occurrence of a permanent cessation event or a pre-cessation event. A permanent cessation event is an announcement that the administrator of the applicable IBOR has ceased or will cease to provide the applicable IBOR permanently or indefinitely. A pre-cessation event is an announcement by the regulatory supervisor for the administrator of LIBOR that one of the LIBOR rates (*i.e.*, Sterling LIBOR, Swiss Franc LIBOR, U.S. Dollar LIBOR, Euro LIBOR or Yen LIBOR) is no longer, or as of a specified future date will no longer be, representative of the underlying market and economic reality that such LIBOR rate is intended to measure and that such representativeness will not be restored. Unlike a permanent cessation event, a pre-cessation event may not be triggered immediately upon an announcement. Instead, a pre-cessation event is triggered upon the first date on which the applicable LIBOR rate becomes non-representative of the underlying market as determined and announced by the regulatory supervisor for the administrator of LIBOR, and this date will be the date provided in the pre-cessation event announcement, even if the applicable LIBOR rate continues to be provided on such date. If a fallback alternative RFR becomes unavailable or is discontinued, the Supplement provides for several fallback rate options. In addition to the permanent cessation event and the pre-cessation event triggers, the Supplement provides for temporary fallback rates that are triggered by non-publication of an IBOR. The Supplement only applies to new derivative transactions. On and after the Effective Date, any new derivative transactions that incorporate the Definitions will automatically include the fallback alternative RFRs and related triggers.

[1] In September 2020, the Alternative Reference Rates Committee, a market participant group convened by the Federal Reserve Board and Federal Reserve Bank of New York, released a Request for Proposals seeking a potential administrator to publish forward-looking SOFR term notes.

Protocol

The Protocol is a standardized multilateral contract amendment that allows market participants to amend existing legacy contracts that reference certain IBORs by adding fallback alternative RFRs and triggers for such IBORs that generally match the amendments made by the Supplement. If a market participant does not need to amend legacy contracts, but wishes to apply fallback alternative RFRs to new derivative transactions after the Effective Date, then use of the Supplement is sufficient and the participant does not need to adhere to the Protocol. On and after the Effective Date and following the decision of both parties to an existing legacy contract to adhere to the Protocol, the Protocol will automatically apply to all applicable existing legacy contracts of both adhering parties and add fallback alternative RFRs and related permanent cessation event and pre-cessation event triggers to such legacy contracts. If a fallback alternative RFR becomes unavailable or is discontinued, the Protocol provides for several fallback rate options and also includes a temporary fallback rate that is triggered by non-publication of an IBOR. The Protocol is similar to other ISDA protocols in that it amends all of a party's existing ISDA documentation. However, unlike other ISDA protocols, the Protocol amends certain repurchase, stock loan, foreign exchange and commodities transactions documented under master repurchase agreements, securities lending agreements and other industry association master agreements. As an alternative to multilateral adherence to the Protocol, ISDA has provided several bilateral amendments that enable a party to bilaterally adopt the Protocol with counterparties, exclude existing documents from the scope of the Protocol, disapply the pre-cessation event trigger or amend the scope and terms of the Protocol with respect to certain existing legacy documents.

While it is expected that many market participants will choose to adhere to the Protocol and utilize the fallback alternative RFRs provided in the Protocol and the Supplement, several risks associated with the transition from LIBOR to fallback rates remain. For instance, there could be differences in the fallback rates and the fallback adjustment methodologies between the loan and derivatives markets. For example, LIBOR cash markets could move to a different SOFR rate and at an earlier point in time than the derivatives markets. Market participants should catalog and inventory their IBOR exposure in their swap and loan portfolios and develop a plan to transition to new benchmark RFRs in existing and new transactions well in advance of the anticipated discontinuation of LIBOR and other IBORs. Adhering to the Protocol may not be appropriate for all parties, and parties should carefully determine whether to accept the standard terms of the Protocol or to negotiate bespoke fallback benchmark rates and adjustment methodologies on a bilateral basis where needed.

Willkie has a dedicated team of attorneys with extensive knowledge and experience in all aspects of the legal issues that may occur in connection with the discontinuation of LIBOR and the transition from LIBOR to alternative rates. We would be pleased to assist on your matters.

Conrad G. Bahlke
212 728 8233
cbahlke@willkie.com

Krystyna Blakeslee
212 728 8111
kblakeslee@willkie.com

Georgia Bullitt
212 728 8250
gbullitt@willkie.com

Henrietta de Salis
+44 20 3580 4710
hdesalis@willkie.com

Athena Eastwood
202 303 1212
aeastwood@willkie.com

Thomas French
212 728 8124
tfrench@willkie.com

J. Christopher Giancarlo
212 728 3816
jcgiancarlo@willkie.com

Rita M. Molesworth
212 728 8727
rmolesworth@willkie.com

Paul J. Pantano Jr.
202 303 1211
ppantano@willkie.com

Deborah A. Tuchman
212 728 8491
dtuchman@willkie.com

Alessandro Turina
212 728 8737
aturina@willkie.com

Alcide D. King
212 728 8374
aking@willkie.com

Neal E. Kumar
202 303 1143
nkumar@willkie.com

James E. Lippert
212 728 8945
jlippert@willkie.com