An Overview of the ISDA IBOR Fallbacks Supplement and Protocol

October 23, 2020

I. Introduction

On October 23, 2020, the International Swaps and Derivatives Association, Inc. ("**ISDA**") published (1) the ISDA 2020 IBOR Fallbacks Protocol (the "**Protocol**") and (2) a supplement to the 2006 ISDA Definitions that adds new IBOR Fallbacks (the "**Supplement**"). The Protocol and the Supplement are scheduled to become effective on January 25, 2021.[1] Collectively, the two publications represent a very significant step in the move away from the use of LIBOR and other benchmarks.

The Supplement amends the definitions applicable to various interbank offered rates ("**IBORs**") under the 2006 ISDA Definitions so that new transactions that incorporate those definitions will "fall back" to alternative reference rates upon the occurrence of specified events. The Protocol is a multilateral contractual amendment that amends existing contracts referencing IBORs to provide for fallbacks that generally track the Supplement.

The Alternative Reference Rates Committee ("**ARRC**") has published best practices that recommend all market participants modify their existing contracts by adhering to the Protocol prior to the effective date. In addition, a number of regulators across the globe, including the UK FCA, have urged market participants to adhere to the Protocol.[2]

This memorandum is intended to provide a general overview of the Protocol and Supplement. It is primarily focused on how these changes will be implemented for USD LIBOR, though the mechanisms for other in-scope IBORs are similar. Further detail on the Supplement and Protocol (in particular, mechanics for adherence and process matters) can be found on the ISDA website.

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1 Further detail on the significance of the effective date is provided below.

2 *See, e.g.*, Edwin Schooling Latter, Director Markets and Wholesale Policy, United Kingdom Financial Conduct Authority, Speech on July 14, 2020 ("The FCA has repeatedly urged market participants from all sectors – sell side, buy side, non-financial, to ensure they are ready for the end of LIBOR by adhering to the protocol that ISDA is producing.").

II. Background

IBORs are benchmark rates that represent the cost of short term, unsecured, wholesale borrowing by banks, based on daily panel bank submissions and then averaged together in different currencies and tenors. In recent years the volume of transactions underlying IBORs has declined; there are approximately $200 trillion of financial contracts referencing USD LIBOR, while on a typical day the volume of three-month wholesale funding transactions by major banks was about $500 million. In 2014 regulators noted the risks associated with continued reliance on IBORs and convened working groups to prepare for a transition. In 2017 the UK's Financial Conduct Authority ("**FCA**") announced that continued publication of LIBOR is not guaranteed beyond 2021.

III. Why Changes Are Necessary

In most derivatives and many other financial transactions, the definitions used for IBORs were not drafted to withstand the benchmark ceasing to exist or becoming problematic from a regulatory standpoint. For example, under the standard ISDA-published definitions used in most derivatives, IBORs are typically defined (1) first, by reference to a published screen and (2) if the screen is unavailable, by a specified person (typically one of the parties to the transaction) conducting a poll that effectively seeks to "manually" replicate the IBOR rate – *i.e.*, by soliciting quotes for rates at which unsecured interbank loans would be made. The definitions do not contemplate what would happen if the rate is not published and a poll is unsuccessful.

It is widely expected that, given the regulatory changes and legal issues discussed above, polling for interbank lending rates will have low chances for success in the event of an IBOR cessation. Moreover, even a successful poll could create a significant amount of legal risk given the lack of liquidity in the interbank market and the absence of an objective source. Given these issues, a very large number of transactions need to be amended to ensure an orderly transition.

IV. What the Supplement Does

Overview: The Supplement is an amendment to the 2006 ISDA Definitions.[3] The amendments made by the Supplement generally provide that, upon certain specified events, references to particular IBORs will "fall back" to alternative reference rates.[4]

3 The ISDA definitions provide a series of standard definitions and terms to be incorporated into contracts. While they are primarily used for derivatives that use ISDA documentation, their usage has expanded over the years. It is not uncommon for other types of interest rate transactions to reference the ISDA definitions.

4 *E.g.*, USD LIBOR will "fall back" to compounded SOFR plus spread (referred to in its to-be-published form as "Fallback Rate (SOFR)").

Issue to Consider. Market participants using other forms of ISDA-published definitions and those not using ISDA definitions will need to determine an approach to incorporating IBOR fallbacks on a forward-looking basis.[5]

Forward-Looking Nature: The amendments made by the Supplement *are forward-looking*. In other words, the publication of the Supplement, by its terms, *does not amend existing transactions*. The Supplement amendments will primarily affect transactions that incorporate the 2006 ISDA Definitions following the effective date.[6] As discussed further below, the Protocol is the standardized approach for amending contracts entered into *before* the effective date.

LIBOR Remains in Short Term. While the amendments to the definitions take place upon effectiveness of the Supplement, these amendments will likely not have an immediate effect on transactions entered into pursuant to the revised definitions. This is because the Supplement leaves the relevant IBOR in place, until specified events occur to trigger the switch to a fallback benchmark.

Currencies. The Supplement amends IBOR definitions relevant for the following currencies: GBP, CHF, USD, Euro, JPY, AUD, CAD, HKD, SGD, THB.

Temporary Triggers. In addition to terms providing for a permanent cessation of an IBOR, the Supplement sets forth provisions that will apply if an IBOR is not published on a temporary basis. These provisions look to whether publication is timely made, and if not, then one would look to a rate recommended by the administrator or a relevant regulator, or, if no such rate is provided, then to the calculation agent (*i.e.*, the party or other person responsible for the rate determination under the contract) in its discretion, but with reference to relevant market factors.

Permanent Triggers.

Upon the occurrence of any of the following specified events, calculations based on an IBOR will switch to a fallback benchmark:

Permanent Cessation. An announcement that the administrator of the relevant IBOR will cease or has ceased to provide the IBOR permanently or indefinitely is made by: (1) the administrator of the IBOR (ICE Benchmark Administration, for LIBOR), (2) its regulatory supervisor (the UK FCA, for LIBOR) or an insolvency official, resolution authority or

5 One approach could be to deem the new transaction to have been amended in accordance with the Protocol, notwithstanding the general backward-looking nature of the Protocol.

6 For example, a transaction that is entered into on January 24, 2021, that references "USD-LIBOR-BBA" will use that term as it has been defined in the past. A transaction that is entered into on January 26, 2021, that references "USD-LIBOR-BBA" will use that term, as amended by the Supplement (*i.e.*, will incorporate fallbacks).

insolvency court for the administrator, or (3) the central bank for the currency of the relevant IBOR.

Pre-Cessation. The Supplement also includes what is commonly referred to as a "pre-cessation" trigger. This would occur, in the case of LIBOR, if the UK FCA were to announce that LIBOR has or will become "non-representative" as of a specified date.[7] In contrast to a permanent cessation, the pre-cessation trigger does not necessarily take effect immediately. It is expected that an announcement would be used to trigger a forward-looking date, and the relevant fallbacks would be implemented as of the forward-looking date referenced in the announcement, not the date of the announcement.

Permanent Fallbacks. The IBOR fallbacks generally follow a standard approach of a specified "risk-free rate" (SOFR, in the case of USD LIBOR), compounded in arrears, observed with a two business-day backward shift and a spread adjustment. In the case of USD LIBOR, "Fallback Rate (SOFR)" will be published and be the rate to be used in a contract using the ISDA fallbacks.

SOFR. The Secured Overnight Financing Rate is a measure of the cost of borrowing cash overnight collateralized by U.S. Treasury securities. It is calculated and published by the Federal Reserve Bank of New York. Further details on SOFR, including historical data and methodology, can be found on the SOFR page on NY Fed's website.[8]

Compounded in Arrears. The version of SOFR to be used would be compounded in arrears, *i.e.*, by using a compounded rate over the current interest period. Note that, unlike other forms of SOFR, the compounded in arrears rate means that final rates will not be known until the end of an interest period.[9]

Backward Shift. Given the timing issue noted above, a two Business Day shift will be applied so that an interest rate calculation period will start two Business Days before the relevant period and end two Business Days before the end.

Spread Adjustment. The spread adjustment is intended to capture the credit component of LIBOR (*i.e.*, because LIBOR is based on *unsecured* transactions but SOFR is based on transactions fully collateralized by U.S. Treasury securities) and ensure a smoother transition

7 The FCA has issued a statement on its support for a "pre-cessation" trigger and details on the "representativeness" determination.

8 *See also* "A User's Guide to SOFR" (April 2019), published by the Alternative Reference Rates Committee.

9 In part for this reason and issues relating to the backward shift, other markets using SOFR as a rate (including various types of loans) may use other forms of SOFR.

from LIBOR. It will be based on a five-year historical median looking at the relevant IBOR and the relevant compounded risk-free rate.[10]

Issue to Consider: The fallback rate used by the Supplement (and the Protocol, as discussed below) is likely to be standard in derivatives markets, at least in the near term. However, market participants that engage in other types of cash products should consider how the ISDA-standard fallbacks interact with other types of products. For example, loans and other cash-market transactions may not necessarily use the same fallback rates or conventions, so adjustments may need to be made to hedges.

Fallback Rate Cessation. As with the approach taken with respect to IBORs, the Supplement sets forth a "waterfall" approach with relevant triggers to be used if the specified IBOR fallback rate (*i.e.*, Fallback Rate (SOFR), in the case of USD LIBOR) were to cease to be provided, temporarily or permanently.

V. What the Protocol Does

In short, the Protocol is a method to amend an *existing* contract to update IBOR references to include fallbacks. Unlike a standard amendment between two parties, the Protocol – as with other ISDA protocols – is a *multilateral* and standardized approach. A party that "adheres" to the Protocol agrees to amend *all of its in-scope contracts* with other adhering parties in the manner set forth in the Protocol (*i.e.*, without negotiation or optionality). The substantive amendments made by the Protocol apply the Supplement to existing transactions.

Scope of Contracts to be Amended. As with most other ISDA protocols, the Protocol amends existing contracts under ISDA documentation, including ISDA master agreements, ISDA credit support documents and confirmations. However, *in addition to* derivatives documented on ISDA forms (and unlike many other ISDA protocols)[11] the Protocol also amends other standard form contracts, including securities lending (MSLA, GMSLA), repurchase agreements (MRA, GMRA) and a number of standardized contracts commonly used in overseas markets.[12]

Issue to Consider: Market participants that adhere to the Protocol should note that the Protocol will amend contracts that are not typically amended by ISDA protocols and consider whether any IBOR references in transactions not documented on ISDA-published forms may

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10 The spread would be set as of the relevant trigger, *including* the pre-cessation trigger (*i.e.*, the *announcement* of non-representativeness would set the spread, even though the new rate would not apply until the relevant date on which the IBOR will no longer be "representative").

11 One exception is the protocol to address stays on "qualified financial contracts," which also amended non-derivatives and was agnostic as to the form of documentation.

12 See the Annex starting on p. 23 of the Protocol for a full list of the non-ISDA-published covered documents.

require further attention.[13] For example, if two adhering parties have entered into a repurchase transaction under an MRA that has bespoke IBOR fallbacks, they would need to separately agree to *not* apply the terms of the Protocol if they wish to preserve the negotiated fallbacks.

Substantive Amendments. The application of the Protocol to contracts that reference the 2006 ISDA Definitions is pretty straightforward: these transactions are amended to apply the Supplement. The Protocol is also fairly straightforward for contracts referencing other ISDA-published definitions. For these transactions, the amendments apply the Supplement, with conforming changes. For transactions that reference "LIBOR" or another IBOR generically, without reference to ISDA-published definitions, the Protocol amendments are somewhat more complicated,[14] though the substantive effect is very similar to the amendments made by the Supplement.

Issue to Consider: The amendments made by the Protocol are standardized and adherence means acceptance without negotiation (unless done on a separate, bilateral basis). As result, market participants with non-standard interest rate terms should closely review their contracts to determine whether the amendments made by the Protocol will fully preserve the economic intent of the original transaction.

Adherence. The Protocol is open to the public. Adherence generally involves submitting an adherence letter via the ISDA website. Once a person adheres, their name will appear on the ISDA website as having adhered. ISDA has indicated that, prior to the effective date, the Protocol will be free for non "ISDA Primary Members." Thereafter, the charge will be $500 to adhere (similar to many other ISDA protocols). As with other ISDA protocols, an agent may adhere on behalf of multiple principals.

Timing. There is currently no cut-off date for adherence to the Protocol, but ISDA reserves the right to designate a closing date by providing 30 days' notice. The effective date of amendments made by the Protocol is generally the later of January 25, 2021 or the date on which the second of the two parties adheres to the Protocol. For example, if two parties adhere on January 24, 2021, all of their in-scope contracts will be amended on January 25, 2021. If a party adheres on January 24 and its counterparty adheres effective on February 1, all in-scope contracts in existence prior to February 1 will be amended on February 1.

Bilateral Forms. In addition to the Protocol, ISDA is publishing a series of bilateral templates that parties could use to apply the terms of the Protocol on a one-off basis. These forms are expected to

[13] For many arrangements the Protocol may have little effect or be inapplicable (for example, most repurchase and securities lending transactions do not typically reference IBORs).

[14] Among other things, given the generic nature of the relevant underlying references, these amendments require a determination of term and currency in some instances and also require setting forth the fallbacks in full rather than by reference to the published Supplement.

be used primarily by non-adhering parties,[15] but could also be used by adhering parties seeking to modify particular terms of the Protocol (*e.g.*, to exclude certain transactions from the scope of the Protocol).

VI. Conclusion

These ISDA publications have been long-awaited and represent a major step in the transition away from LIBOR. When combined, the Protocol and Supplement should have the effect of providing for the orderly transition of an extremely large portion of IBOR-referencing contracts. However, a significant amount of work remains, both to ensure use of the ISDA-published forms and to accommodate those for whom the ISDA approach provides an imperfect solution to IBOR issues.

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15 For example, a person that has only entered into one derivative might prefer a bilateral amendment with its counterparty rather than paying the fee and using the global approach offered by the Protocol.