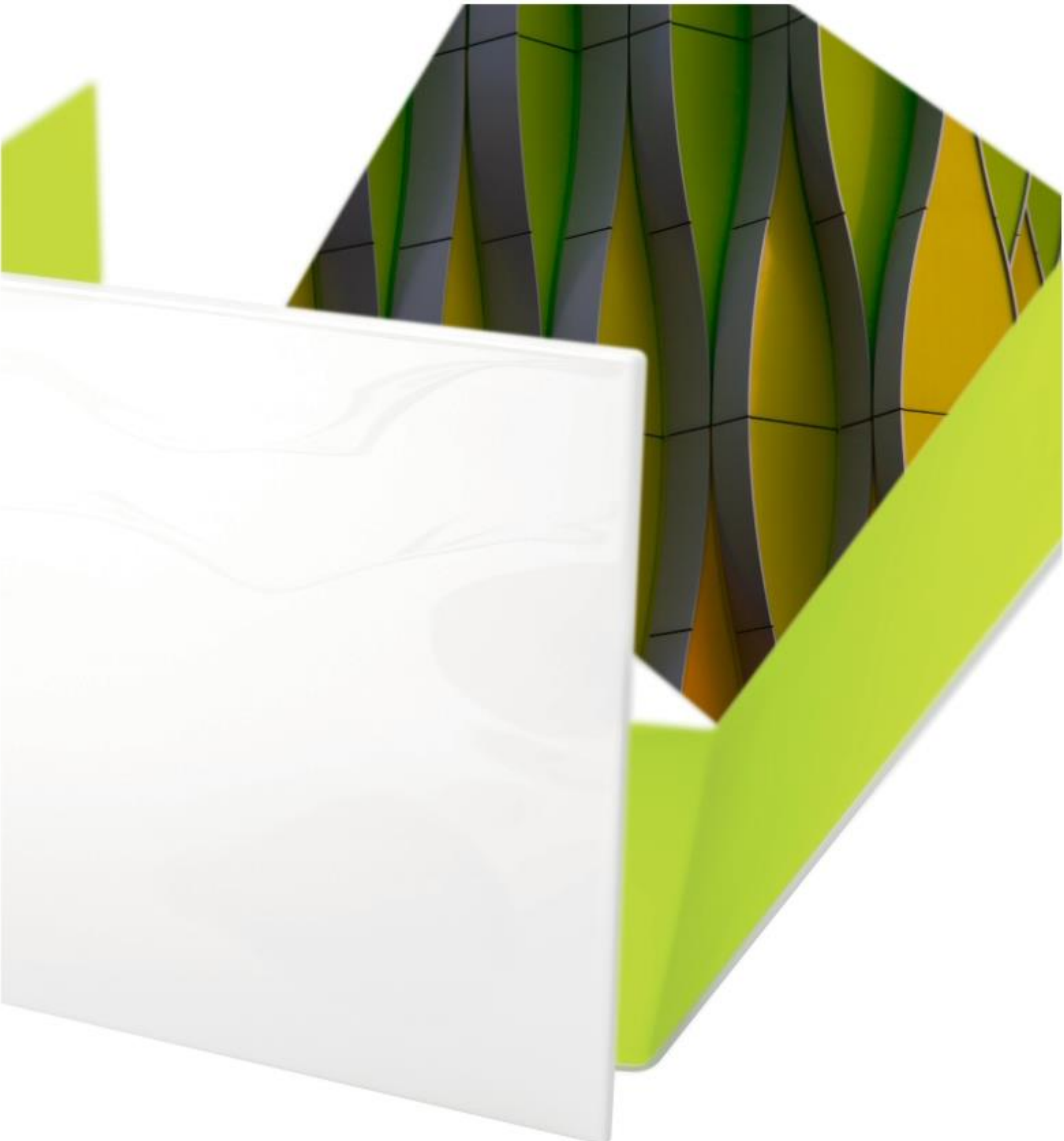

ISDA 2020 IBOR Fallbacks Protocol: What you need to know

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Hogan Lovells

The International Swaps and Derivatives Association, Inc. (ISDA) has published the ISDA 2020 IBOR Fallbacks Protocol (the IBOR Fallbacks Protocol). This client alert sets out key issues counterparties may wish to consider in relation to the IBOR Fallbacks Protocol.

Who should read this client alert?

If you have derivatives contracts that are linked to, or refer to, floating rate indices you should read this client alert because your existing and future contracts may be affected and you may be receiving communications from your dealers to modify your contracts. This could affect commercial end users of derivatives, including corporates, funds, pensions funds, insurers and, of course, sell side financial institutions.

When will the process of amending derivatives contracts for LIBOR transition via a protocol begin?

Now. ISDA has launched the IBOR Fallbacks Protocol and any entity can adhere to it, not just ISDA members. The amendments introduced by the IBOR Fallbacks Protocol will then take effect on 25 January 2021.

What has happened?

ISDA has launched the much anticipated IBOR Fallbacks Protocol, which is designed to assist derivatives market participants with their IBOR transition plans. Adherence to the IBOR Fallbacks Protocol is seen by regulators across the world as a key part of firms' LIBOR transition plans and was described by Andrew Bailey, Governor of the Bank of England, as an important step in the LIBOR "endgame" and by the Board of Governors of the Federal Reserve System (the **Fed**) as playing an important role in an orderly transition away from LIBOR. By adhering to the IBOR Fallbacks Protocol, derivatives counterparties would be incorporating the new robust fallback rates that would apply in the event of a permanent cessation of a key interbank offered rate (**IBOR**) and upon a non-representative determination for LIBOR (the London Interbank Offered Rate) into legacy deals with other adhering counterparties.

With UK and U.S. regulators confirming that, notwithstanding the current COVID-19 pandemic, there is no change to the end of 2021 date set by Andrew Bailey in his speech in July 2017 (after which time the UK Financial Conduct Authority (**FCA**) will no longer be persuading or compelling banks to submit quotes to LIBOR), there has been increased focus on transitioning existing deals to alternative risk-free reference rates (**RFRs**) before this time. The FCA, along with the Fed, has said it expects firms to be taking appropriate steps to ensure they can transition to alternative RFRs well before the end of 2021.

In the U.S., the Fed and the Federal Reserve Bank of New York convened the Alternative Reference Rates Committee (the **ARRC**) to help ensure a successful transition to a "more robust" reference rate. In its recommended best practices, the ARRC recommended that "dealers and other firms with significant derivatives exposures adhere to the IBOR Fallbacks Protocol" promptly after it is published and before the amendments to legacy transactions take effect.

What IBORs does the IBOR Fallbacks Protocol cover?

As well as LIBOR (with no reference to the currency), the following IBORs are in scope of the IBOR Fallbacks Protocol: Sterling LIBOR (**GBP LIBOR**), Swiss franc LIBOR, U.S. dollar LIBOR, euroLIBOR, the euro interbank offered rate (**EURIBOR**), the Japanese yen Tokyo interbank offered rate (**TIBOR**), the euroyen Tokyo interbank offered rate (**euroyen LIBOR**), the Australian bank bill swap rate, (**BSSW**) the Canadian dollar offered rate (**CDOR**), the Hong Kong interbank offered rate (**HIBOR**), the Singapore dollar swap offer rate and the Thai baht interest rate.

What are the new fallback rates?

ISDA has been working to amend certain "floating rate options" in the 2006 ISDA Definitions to include contractual fallback provisions for the IBORs for some time, so that, in the event that one or more IBORs are discontinued, derivatives contracts would fall back to adjusted versions of the RFRs as replacement rates.

The new fallbacks will be adjusted versions of the RFRs identified by public or private sector working groups in each jurisdiction as alternatives to the IBORs. The adjusted RFR in the relevant currency would apply as a fallback following a permanent cessation of the IBOR in that currency and, in respect of any LIBOR, following a determination by the FCA that LIBOR in that currency was no longer representative of its underlying market even if it continues to be published.

Replacement rates vary by jurisdiction. In the UK, the Working Group on Sterling Risk-free Reference Rates selected the Sterling Overnight Index Average (**SONIA)** as its proposed benchmark for use in sterling derivatives and relevant financial contracts. In the U.S., the ARRC has recommended the Secured Overnight Financing Rate (**SOFR**) as the replacement to LIBOR. SOFR is a secured rate, unlike LIBOR or SONIA, as it is based on overnight repo transactions secured by US Treasuries.

In the EU, the European Central Bank's working group for euro risk-free rates recommended that the euro short term rate (**€STR)** be used as the risk-free rate for the euro area, replacing the euro overnight index average (**EONIA**). EURIBOR has been reformed though market participants are strongly urged to ensure they have robust written fallbacks as EURIBOR's continued existence is not guaranteed.

For information about the IBORs and alternative RFRs, their administrators and working groups across jurisdictions please see here.

How are the new fallback rates different from the IBORs?

The RFRs are fundamentally different from the IBORs as they do not yet have a term structure but are "risk free" overnight rates, set in arrears. The RFRs also do not include an element of counterparty credit risk.

Given that the IBORs have a term structure and a credit element and the RFRs are overnight rates with no credit component, adjustments are needed to the RFRs for legacy contracts to ensure that derivative contracts that were originally negotiated to reference an IBOR continue to meet the original economic objectives of the counterparties to the extent possible once the new fallbacks take effect. As a result of several market wide ISDA consultations, the new fallback rates that will be used in legacy contracts will be the RFRs compounded over the relevant IBOR period with a spread adjustment added to the compounded rate. The spread adjustment will be based on the median over a 5-year period of the historical differences between the IBOR in the relevant tenor and the relevant RFR compounded over each corresponding period.

The adjustments and methodologies that were adopted in the IBOR Fallbacks Protocol could have different economic consequences and should be evaluated when deciding whether to adhere to the IBOR Fallbacks Protocol.

What is the purpose of the IBOR Fallbacks Protocol?

The IBOR Fallbacks Protocol enables counterparties to incorporate the new floating rate options (with the amended fallbacks) into existing uncleared derivatives transactions with other adhering parties without having to amend on a bilateral basis the documentation governing such transactions. See "*How does the IBOR Fallbacks Protocol work?*" below for further information.

Do I need to adhere to the IBOR Fallbacks Protocol?

Although adherence to the IBOR Fallbacks Protocol is voluntary, regulators across the globe have urged regulated entities to sign up early.

The Financial Stability Board (the **FSB**) has released a statement welcoming ISDA's announcement and encouraging adherence:

"*The FSB encourages adherence to the Protocol as a tangible step that can be taken by both financial and non-financial firms to avoid disruptions in covered derivatives contracts if the IBOR they currently reference is discontinued or, in the case of LIBOR, becomes non-representative.*"

The Working Group on Sterling Risk-free Reference Rates has issued a joint statement, with the Bank of England and FCA also encouraging adherence: "*the Working Group strongly encourages early adherence to the Protocol by both financial and non-financial firms.*

The ARRC has also issued a similar announcement in support:

"*In line with its Recommended Best Practices, the ARRC encourages market participants to adhere to the Protocol before it takes effect.* "

In addition, under Article 28(2) of the EU Benchmarks Regulation, certain EU and UK regulated entities have a regulatory requirement to include robust written fallbacks in their contractual documentation. Edwin Schooling-Latter of the FCA has said that signing the IBOR Fallbacks Protocol will meet this

regulatory requirement and that the FCA will be asking hard questions as to why UK regulated firms have not signed up to the IBOR Fallbacks Protocol.

Firms that are not regulated by a financial regulator, such as commercial end-users, can expect their dealer counterparties to contact them regarding adherence to the IBOR Fallbacks Protocol and commercial end users should expect to be encouraged to adhere.

If you decide not to adhere to the IBOR Fallbacks Protocol or include the amendments on a bilateral basis and subsequently an IBOR is no longer available, it is unlikely that major dealers would be willing or able to fulfil the standard fallback and give quotes. Consequently, there will be significant uncertainty as to the applicable rate.

How does the IBOR Fallbacks Protocol work?

A protocol is a multilateral contractual amendment provision that is used to make standard amendments to ISDA documentation among adhering counterparties, and the IBOR Fallbacks Protocol will work in much the same way as previous ISDA protocols. By adhering to the IBOR Fallbacks Protocol, you would be agreeing that your legacy derivative contracts with other adherents to the IBOR Fallbacks Protocol will include the amended floating rate option for the relevant IBOR and will therefore include the new fallbacks that would take effect upon a permanent cessation of certain key IBORs or upon a non-representative determination for any LIBOR. The fallbacks will be adjusted versions (with the spread adjustment added) of the RFRs identified by public or private sector working groups in each jurisdiction as alternatives to the IBORs. The adjusted RFR in the relevant currency would apply as a fallback following a permanent cessation of the IBOR in that currency and, in respect of any LIBOR, following a determination by the FCA that LIBOR in that currency was no longer representative of its underlying market (either immediately or as at a future date) even if it continues to published (which would trigger the pre-cessation fallbacks as the permanent cessation fallbacks would not apply). If there is a temporary technical issue with the publication of the relevant IBOR, the new fallbacks would not kick in.

Details of the IBOR Fallbacks Protocol together with a list of frequently asked questions can be found at the following links:

- IBOR Fallbacks Protocol
- IBOR Fallbacks Protocol FAQs

How can I see if a counterparty has already adhered to the IBOR Fallbacks Protocol?

From the launch date, a list of adhering parties will be available on the ISDA website.

When and how can I adhere to the IBOR Fallbacks Protocol?

There is currently no cut-off date for adherence, although ISDA may subsequently designate a closing date. You will need to download and sign the Adherence Letter and upload as a pdf. Once adherence is confirmed by ISDA, you should receive an email confirming adherence.

Can an investment manager or other agent adhere to the IBOR Fallbacks Protocol on behalf of its clients?

Yes, an investment manager or agent can adhere to the IBOR Fallbacks Protocol on behalf of some or all of its clients and there are various options in the IBOR Fallbacks Protocol in order to facilitate this. This includes adhering on behalf of an identified list of clients and adhering on behalf of all clients except a list of excluded clients so agents can adhere on behalf of an entity group as well as for a single legal entity only.

When do the amendments in the IBOR Fallbacks Protocol take effect?

The IBOR Fallbacks Protocol will take effect on the Protocol Effective Date, which is 25 January 2021, provided that both counterparties have adhered to the IBOR Fallbacks Protocol by then. If one or both of the Adhering Parties adheres to the IBOR Fallbacks Protocol after the Protocol Effective Date, the IBOR Fallbacks Protocol will take effect in relation to covered contracts entered into by the relevant Adhering Parties on the date on which the later of the two parties adheres to the IBOR Fallbacks Protocol.

What transactions does the IBOR Fallbacks Protocol cover?

The IBOR Fallbacks Protocol covers ISDA Master Agreements, Credit Support Agreements and Confirmations that reference a relevant IBOR. It does not cover documentation for cleared transactions, including transactions under a 2016 ISDA/FIA Client Cleared OTC Derivatives Addendum: counterparties should check the rules of the relevant central counterparty which may contain the terms of the IBOR Fallbacks Supplement.

In addition, some non-ISDA documents that contain references to key IBORs will be in scope of the IBOR Fallbacks Protocol, provided that those documents are listed as "Additional Master Agreements" or "Additional Credit Support Agreements" by ISDA in the Protocol.

The IBOR Fallbacks Protocol will only apply to transactions with counterparties that have also adhered to the IBOR Fallbacks Protocol.

If there are certain contracts that you do not wish to be covered by the IBOR Fallbacks Protocol, you can exclude certain contracts on a bilateral basis. See "*How could I amend my deals bilaterally?*" below for further information.

What are the trigger events for the new fallback rates?

The fallbacks in the IBOR Fallbacks Protocol will be triggered in the event of any of the following Index Cessation Events:

- a public statement or publication of information by or on behalf of the administrator of the relevant IBOR announcing that it has ceased or will cease to provide the relevant IBOR permanently or indefinitely, provided that, at that time, there is no successor administrator that will continue to provide the relevant IBOR;

- a public statement or publication of information by the regulatory supervisor for the administrator of the relevant IBOR, the central bank for the currency of the relevant IBOR, an insolvency official with jurisdiction over the administrator or a court or an entity with similar insolvency or resolution authority over the administrator, which states that the administrator of the relevant IBOR has ceased or will cease to provide the relevant IBOR permanently or indefinitely, provided that, at that time, there is no successor administrator that will continue to provide the relevant IBOR; and

- a non-representativeness announcement by the FCA in respect of LIBOR for the 5 currencies in which it is published (but this will not apply for the other IBORs) where the intention of such an announcement is to trigger the pre-cessation fallbacks in the IBOR Fallbacks Protocol.

When would the fallbacks kick in and new rates apply?

In the event of a permanent cessation of an IBOR, the derivatives contract will reference the all-in fallback rate (i.e. the compounded RFR plus the spread adjustment), starting from the point at which the IBOR could not be observed for the relevant observation date because it had been permanently discontinued.

It may be that discontinuation could occur for all of the tenors of an IBOR at once, or just for some tenors and if only certain tenors are discontinued, but at least one longer tenor and one shorter tenor remain, then linear interpolation using the remaining tenors would apply prior to the use of the new fallback.

What would happen to my derivatives contract if the permanent cessation fallbacks are triggered?

Although the floating rate option referenced in your contract will remain unchanged, the price source within the description of the floating rate option will move to the Bloomberg publication of the new all-in fallback rates based on the relevant RFR. The observation date will typically move to a date that is around the end of the relevant period, although other conventions in your confirmation such as the payment date and day count fraction for the original IBOR will remain unchanged.

How will the new fallbacks be calculated?

The adjusted RFRs will be calculated by combining the relevant compounded in arrears RFR and a spread adjustment based on a 5-year historical median of the differences between the IBOR and the RFR.

The compounding in arrears calculation will be based on the compounding formula used in overnight index swaps, but a backward shift will apply to the period of calculation so payment amounts are known at least two days prior to payments being due.

Where can I find the new all-in rates?

Bloomberg Index Services Limited (**BSIL**) was selected to calculate and publish the adjusted RFRs and has been calculating and publishing the fallbacks since 21 July 2020.

BSIL intends to make the following calculations available:

- the adjusted RFR (compounded setting in arrears for each relevant term, daily compounding of publicly available RFRs);
- the spread adjustment (the median of the historical differences between the IBOR for each tenor and the compounded RFR for that tenor over the preceding 5 year period); and
- the "all in" IBOR fallback rate (a combination of the adjusted RFR and the spread adjustment for each relevant tenor).

for the following IBORs across various tenors: the Australian dollar Bank Bill Swap Rate (**BBSW**), CDOR, Swiss franc LIBOR, EURIBOR, euroLIBOR, sterling LIBOR, HIBOR, euroyen TIBOR, yen LIBOR, TIBOR and US dollar LIBOR.

BSIL will become the new price source for the relevant floating rate option as it will replace the price source for the original IBOR. As the new price source, the real time data will become available through authorised redistributors and is publicly available on the Bloomberg website on a delayed basis.

What is a pre-cessation fallback for LIBOR?

A pre-cessation fallback or temporary cessation for any LIBOR would be triggered if the FCA made an announcement that LIBOR is no longer capable of being representative, either as at that day or a future date, even if it continues to be published (and therefore permanent cessation fallbacks would not apply). In the event of such an announcement, there would be an Index Cessation Event and those contracts would switch to the alternative fallback rates although, if the announcement had a future effective date, the contracts would not convert until that future date with the spread adjustment nonetheless being fixed as at the date of the non-representativeness announcement.

In the event of a non-representativeness determination by the FCA, the new pre-cessation fallbacks would apply to the relevant LIBOR contracts. A non-representativeness announcement could be made in respect of all LIBOR tenors or for some tenors before others. As the proposed new powers for the FCA to change LIBOR's methodology (such that there might be some form of synthetic LIBOR) would only kick in after the FCA has declared LIBOR to be unrepresentative, this would not affect any derivatives contracts under the IBOR Fallbacks Protocol where the pre-cessation fallbacks have been triggered.

How could I amend my deals bilaterally?

You may wish to incorporate the terms of the IBOR Fallbacks Protocol on a bilateral basis, for example if your derivative is linked to a cash product (see below) or if you wish to disapply the pre-cessation provisions or include additional documents. Alternatively, you may decide to exclude one or more existing confirmations, master agreements or credit support documents from the scope of the IBOR Fallbacks Protocol where you have already included negotiated fallbacks. This would result in reversing the effect of adhering to the IBOR Fallbacks Protocol such that the negotiated fallbacks would apply in respect of those particular excluded contracts.

ISDA has produced a suite of template documents with various options in order to assist counterparties who may wish to incorporate the new fallbacks on a bilateral basis, which is available on the ISDA website here, together with an outline of bilateral forms for IBOR fallbacks.

As an alternative to amending the contract bilaterally, other options include, closing-out at the transaction or portfolio level and entering into new transaction(s), entering into compression exercises that increase exposure to the alternative rates while reducing exposure to the IBORs or entering into offsetting basis swaps, although the financial, tax and regulatory treatment of such exercises will need to be considered. The new transaction would use the floating rate options in the 2006 ISDA Definitions for the alternative rates and would use the conventions (such as payment date) agreed by the parties which, for standard interest rate swaps, would most likely be the conventions used for trading in the products based on the alternative rates (not the IBOR).

What do I need to think about if my derivative transaction is linked to a securitization, bond or loan?

If you have a linked cash transaction, you may wish to incorporate the new IBOR fallbacks on a bilateral basis. You may decide to adhere to the IBOR Fallbacks Protocol but exclude certain transactions. ISDA has contemplated this scenario and provided template wording whereby the floating rate option in the derivative transaction could continue to track the reference benchmark in the related cash product.

On both sides of the Atlantic regulated lenders are now required to include contractual conversion mechanisms in new or refinanced LIBOR products. In the U.S., this is in the form of the ARRC recommended hardwired language whereby on the occurrence of specified triggers the loan will switch from USD LIBOR to SOFR and, in the UK, this is either by including hardwired language for the switch from GBP LIBOR to SONIA (or other relevant RFR), or else contractual provisions documenting how transition will be achieved before the end of 2021 (and the Loan Market Association has published wording to assist). Banks and other regulated lenders are now getting to grips with these new requirements and will be keen to ensure that linked loans do not carry mis-match interest rate risk. As legacy linked loans start to be repapered and transitioned away from LIBOR, which should start in earnest from now on, lenders will similarly be alive to the same mis-match risk and looking for the linked derivative to be bilaterally amended so as to continue to track the loan reference rate.

What about new deals?

ISDA has also published a Supplement (the **IBOR Fallbacks Supplement**) for the relevant IBORs to the 2006 ISDA Definitions that is designed for use in connection with new transactions.

What does the IBOR Fallbacks Supplement do?

The IBOR Fallbacks Supplement updates the Rate Options for relevant IBORs to include new fallbacks in the event of a permanent cessation of those IBORs and, in the case of the LIBOR Rate Options, in the event of a "pre-cessation" event. In the event of a permanent cessation, the relevant IBOR will first fallback to a term adjusted RFR for the relevant currency plus a spread adjustment published by Bloomberg, then further specific fallbacks apply in respect of the relevant rate.

The IBOR Fallbacks Supplement also introduces fallbacks in the event that a relevant IBOR is temporarily unavailable (for example if the IBOR has not been published on the relevant date but no Index Cessation Event has occurred in respect of that IBOR).

When will the amendments in the IBOR Fallbacks Supplement take effect?

The amendments in the IBOR Fallbacks Supplement will also take effect on 25 January 2021, the Protocol Effective Date. After that date, all new transactions that are entered into that incorporate the 2006 ISDA Definitions and the IBOR Fallbacks Supplement will include the amended floating rate options. Any transactions entered into prior to that date will continue to be based on the existing 2006 ISDA Definitions without the amended floating rate options with the new fallbacks.

The IBOR Fallbacks Supplement is also available on the ISDA website here.

What else to look out for?

ISDA is currently working on a revised version of the 2006 ISDA Definitions, the 2021 ISDA Interest Rate Definitions, which will incorporate the amended IBOR fallbacks.

What would happen to legacy deals that continue unamended to reference the old floating rate options?

Derivatives contracts that are not amended would fall back to the existing fallbacks for the relevant IBOR in the 2006 ISDA Definitions in the event of a permanent cessation of an IBOR, namely a reference bank poll. However, there is considerable uncertainty around whether this mechanism would even work in practice after the end of 2021 and even if an IBOR rate did continue to be published it may no longer be

representative or provide the same economic outcome as the original contract, which could result in disputes among counterparties.

Although discussions are ongoing in various markets about legislative solutions for “hard legacy” contracts, there is currently no clarity as to how the various legislation solutions would affect particular transactions. Regulators have warned market participants that they should not wait for these solutions but should instead actively transition legacy contracts that are capable of being transitioned as relying on legislative solutions will mean counterparties no longer have control over the economic terms of their transactions.

Next steps

You should consider carefully whether your organization will be adhering to the IBOR Fallbacks Protocol or, alternatively, whether you will be amending documentation on a bilateral basis to incorporate the new fallbacks into your legacy deals. If you are a non-dealer and your trading relationships are with dealers, you will likely be contacted by your dealer to either adhere to the IBOR Fallbacks Protocol or enter into bilateral amendments. You may wish to sign up to the IBOR Fallbacks Protocol but exempt certain transactions from it, such as hedging transactions linked to cash products, which you may decide to amend such that the derivative follows the reference rate in the linked cash product. When deciding whether to adhere to the IBOR Fallbacks Protocol or amend your contracts bilaterally, you should also consider the economic, regulatory, tax, accounting and hedging implications both in respect of the contracting entity and of the relevant jurisdiction.

In addition to reviewing carefully your derivatives documentation and the IBOR Fallbacks Protocol, you should reach out to your counterparties in order to ascertain whether they intend to adhere to the IBOR Fallbacks Protocol or whether they are amending documentation on a bilateral basis.

This note is for guidance only and should not be relied on as legal advice in relation to a particular transaction or situation. Please contact your normal contact at Hogan Lovells if you require assistance or advice in connection with any of the above.

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