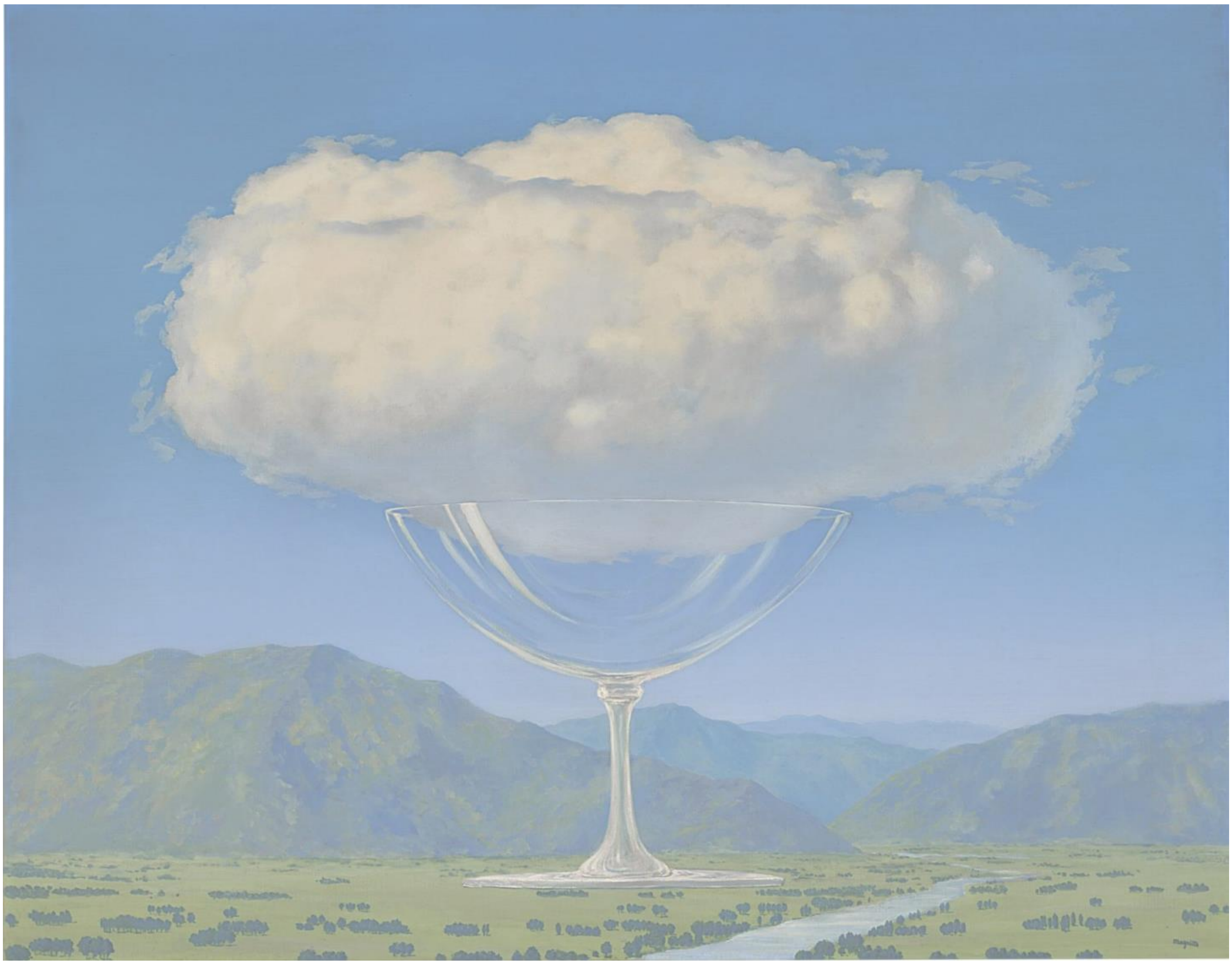

IBOR Update

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This is the first in a series of updates to our white paper published in October 2019.[1] We have previously discussed that the fallback mechanism incorporated into existing documentation was widely recognised as not fit for purpose in the event of a permanent cessation of LIBOR. An event of non-publication of a benchmark rate would have typically required market polling as a fallback to calculate the missing rate.

Market polling is not a manageable process for dealing with a permanent cessation of a benchmark. This is especially relevant in the case of LIBOR, where a permanent cessation is now expected following the FCA statement that panel banks will no longer be compelled to produce a LIBOR submission post end-2021.

Regulatory supported working groups in each jurisdiction determined that the fallback rates would be adjusted versions of the risk-free rates (**RFR**s). However, inherent structural differences between IBORs and RFRs will require an adjustment to the relevant RFR to minimise the value transfer between counterparties on existing transactions once a fallback rate takes effect. Industry consultations on the adjustment methodology decided that the RFRs would be compounded over the relevant IBOR period with a spread adjustment added to the compounded rate. The spread adjustment will be based on the median of the historical differences between the IBOR and the RFR compounded over each corresponding tenor using a five-year observation period. The adjusted RFR will then become the fallback under the new 2006 Definitions in the event of a permanent cessation of an IBOR.

The new definitions are designed to create a more robust fallback mechanism.

On 1 October 2020, a confirmation from the US DOJ that it saw no immediate competition issues with the ISDA fallback process paved the way for delivery of, arguably, the most significant milestone so far in the IBOR transition.

On 9 October 2020, ISDA announced it would launch the IBOR Fallbacks Supplement to the 2006 ISDA definitions and the ISDA 2020 IBOR Fallbacks Protocol on 23 October 2020, which it has now done. With a minimum of three months needed for participants to sign up to the Protocol, the Supplement and the amendments made by the Protocol will take effect on 25 January 2021.

These changes will automatically apply to all derivatives referencing the 2006 ISDA Definitions which will be executed once the Supplement comes into effect, meaning that from that date, the new fallbacks will automatically apply to all new derivatives that incorporate the 2006 ISDA Definitions. Legacy derivatives that existed prior to this date will incorporate the new fallbacks if both counterparties have adhered to the voluntary protocol or as a result of a bilateral agreement to incorporate the revisions.

In the case of LIBOR, an additional pre-cessation trigger exists where the adjusted RFR would also apply as a fallback following a determination by the FCA that a particular currency or tenor LIBOR is no longer representative of an underlying market, even if it continues to be published.

[1] https://www.solum-financial.com/wp-content/uploads/2019/10/IBOR-Reform.pdf

The new fallback provisions provide the market with a safety net that removes the fear of market disruption and financial instability following a permanent cessation of a benchmark IBOR. However, the regulators remain united in calls for market participants to voluntarily transition contracts to the RFRs prior to a cessation event by bilateral negotiation. Bilateral negotiations to amend legacy trades replacing IBOR with the new RFR prior to a cessation event would allow firms to avoid the adjustment mechanisms for fallbacks by agreeing to settle any PV change upfront. This would also lessen the operational impact of an alternative big bang approach which relies on the fallbacks as the sole mechanism of transition.

The FCA had previously indicated that an announcement could be made about the end of LIBOR at the end of 2020. This had originally been expected to coincide with the effective date of the ISDA protocol. The delay of the protocol to January 25th means it remains to be seen if the FCA will press ahead with an announcement in December or defer until early 2021.

This is important as, under the pre-cessation terms of the Protocol, an FCA announcement of non-representativeness would mark the end of the five-year look back period used to calculate the fallback adjustment spreads. In recent communications, ISDA have confirmed that the spread adjustment would become static at the time of an FCA announcement. So, even though a Libor may continue to be published, following an FCA declaration of non-representativeness, the spread adjustment for switching a contract from a Libor setting to the relevant RFR at any future time will be known.

Additionally, knowing the exact adjustment that will be applied may aid the take-up of the voluntary protocol for some market participants especially on the buy-side. Setting the spreads earlier than the end of 2021 would also be beneficial to the transition process for products other than derivatives, particularly in the loan market, which in itself may be an added reason to expect an FCA announcement.

Notwithstanding this, ISDA's announcement that the spread adjustment would be based on a historical 5-year lookback period has already resulted in a repricing of the observable forward basis market to the historically calculated spread.

Convergence of the forward market together with the limited impact of future observations on a 5-year window that will close in the near future has removed much of the volatility associated with the spread calculation. As a result, the market is now fairly priced for an announcement in Q1 2021, with a 3-month GBP adjustment of approx. 12.4 bps and a 3-month US Dollar adjustment of approx. 26.1 bps.[2] Although the exact spreads will be calculated following an FCA announcement, they are unlikely to diverge much from these levels if the market is correct about the FCA timetable.

It is also possible that the IBA, the Libor administrator, may voluntarily decommission part of the LIBOR rate suite raising the potential for an FCA announcement to be coupled with a permanent cessation of some LIBOR fixings prior to the expected end 2021 date.

There have been concerns about the voluntary nature of the protocol as adherence is key to a successful IBOR transition. It is not surprising therefore that recent statements have been

[2] As at 26 Oct 2020.

issued by UK RFRWG, the BOE and FCA, the ARRC and the FSB all encouraging market participants to adhere to the protocol. In addition, EU BMR requires regulated entities to have robust written fallbacks in their contractual documentation. The FCA has stated that adherence to the Protocol would satisfy this regulatory requirement, potentially implying some form of regulatory sanction for those that do not adhere to the protocol.

It is worth noting that the clearing houses will implement the fallbacks in all legacy cleared derivatives contracts as of the effective date, which will help ensure a wide acceptance of the Protocol in the bilateral market. Market expectations are that adherence to the Protocol will be high, with few holdouts requiring bilateral negotiations.

Liquidity continues to grow both in terms of absolute volume and duration in the RFRs, notably in Sonia. The successful October migration from Fed Funds to SOFR discounting at the CCPs is expected to accelerate the growth of SOFR trading. Both the UK and US working groups have planned milestones where market IRS quotes default to be against the RFR rather than Libor, which would further switch liquidity from Libor to the RFR.

However, a material market change in Libor liquidity could impact the CCPs' ability to efficiently manage risk in the event of a default. As such, this could pressurise CCPs to enact the powers contained within their rule books and migrate cleared trades to RFRs prior to a permanent Libor cessation. The basis risk introduced by a bifurcation of cleared vs non-cleared derivative markets together with the knock-on effects for the lending markets would be problematic. In particular, this could result in stranded contracts for those market participants that have not adhered to the Protocol.

Ongoing consultations between the CCPs and its members are aimed at ensuring that any such pre-cessation switch by the CCPs would be synchronised with a similar switch in the bilateral market. Market expectation is that the cleared and non-cleared markets will be successfully co-ordinated and in line with the end of 2021 timeline for a permanent Libor cessation.

With the publication of the Supplement and the Protocol, the derivatives market has a clearer view of the mechanics of the transition and the timetable itself. A successful transition still has hurdles. In our next update, we will address the transition of the aptly named "tough legacy" contracts and to what extent derivatives solutions can be used to ensure consistency with cash markets.