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TRAVERS SMITH

LIBOR Transition Toolkit: ISDA's IBOR Fallbacks Protocol and the IBOR Fallbacks Supplement to the 2006 ISDA Definitions

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1 Overview

Market participants will be aware that that the Financial Conduct Authority ("**FCA**") has stated they should not rely on LIBOR being available beyond 31 December 2021 ("**Cessation Day**") and that the FCA and the Bank of England ("**BoE**") could, prior to the Cessation Day, issue a statement that LIBOR is no longer representative. For a more in-depth overview, please see our full note on LIBOR cessation here.

As the market responds to the LIBOR transition timetable set-out by the Working Group on Sterling Risk-Free Reference Rates (the **"RFR WG**"), efforts to transition LIBOR referencing agreements to Risk-Free Rates ("**RFRs**") have intensified in 2020.

In keeping with the RFR WG's statement that LIBOR transition should be 'market led', the International Swaps and Derivatives Association, Inc. ("**ISDA**") has been at the forefront of the LIBOR transition process in the derivatives market.

Since the outset of the LIBOR transition discussions, market participants have been looking for an effective way to address transition in their derivatives agreements. A recurring concern has been the time and cost impact, and potential execution risk, that amending LIBOR referencing contracts bilaterally will have on businesses. In response to those concerns, on 23 October 2020, ISDA launched:

(1) the ISDA 2020 IBOR Fallbacks Protocol (the "**Protocol**"); and

(2) the IBOR Fallbacks Supplement to the 2006 ISDA Definitions (the "**Supplement**").

In summary:

- The Protocol enables adhering parties to 'bulk convert' covered legacy transactions referencing IBORs to RFRs (including the relevant adjustments, as set out in *'Fallback Rates and Adjustment Calculations*' below) upon the occurrence of certain cessation triggers.
- The Supplement will incorporate RFR fallbacks into 'new' covered transactions that are entered into from the Effective date of the Protocol and the Supplement, being 25 January 2021 (the "**Effective Date**").

Market participants can adhere to the Protocol on ISDA's website and will continue to be able to do so once the Effective Date has passed. Wide adoption by market participants is anticipated, but caution should be taken to ensure that adherence does not have unintended negative impacts on the adhering party's derivatives and other agreements. We discuss this further in paragraph 3 of this note.

2 What do the protocol and the supplement do?

2.1 The Protocol

Where parties adhere to the Protocol, certain LIBOR referencing agreements (referred to as covered legacy agreements) will be amended (from the Effective Date) to include the RFR fallback mechanics included in the Protocol. Adherence has the benefit of transitioning

multiple legacy agreements at the same time, but a key question is: which LIBOR referencing agreements are covered by the Protocol?

Scope of the Protocol

Careful consideration should be given to which agreements are affected by the Protocol and to whether parties want the terms of the Protocol incorporated into all of those agreements.

The Protocol is broad in scope. It covers not only uncleared over-the-counter derivatives transactions under an ISDA Master Agreement and the relevant ISDA credit support documents but it also affects other types of transactions and documents, including securities financing transactions documented under Global Master Repurchase Agreements ("**GMRAs**") and Global Master Securities Lending Agreement ("**GMSLAs**").

If a party intends to adhere to the Protocol but wishes to exclude certain agreements (for example, to carve out any agreements which relate to cash-product linked interest rate hedging), then exclusions can be agreed bilaterally with counterparties (ideally in advance of adherence).

ISDA has published a number of bilateral amendment agreements (available here), which can be used to:

i. apply the terms of the Protocol to an agreement without adhering to the Protocol;

ii. exclude documents from the Protocol's application;

iii. include documents that are not covered by the Protocol so that they are subject to the Protocol mechanics; and

iv. disapply pre-cessation provisions of the Protocol.

It is unlikely that the bilateral amendment agreements promulgated by ISDA will cater for all circumstances applicable between market participants. In some cases (for example, when working with cash-product linked interest rate hedging), bespoke drafting will be required and this will likely result in more complex and time-consuming negotiations. Further due diligence may need to be undertaken to understand the impact of the Protocol on such arrangements.

2.2 The Supplement

From the Effective Date, the Supplement will amend the 2006 ISDA Definitions to incorporate the new RFR fallbacks. Where an agreement references the 2006 ISDA Definitions is executed on or after the Effective Date, the changes to the fallback rate will be applied automatically.

2.3 Fallback Rates And Adjustment Calculations

Due to the inherent structural differences between IBORs and RFRs (please see our full note on LIBOR cessation here for more detail), it is inevitable that transition from LIBOR to an RFR will have an impact on the economics of agreements that parties originally struck by reference to LIBOR. Accordingly, ISDA (following market consultation) has determined that adjustments to RFRs are required to ensure that transition has as limited an impact as possible on existing agreements.

Under both the Protocol and the Supplement the fallback rates that will replace the IBORs are based on adjusted overnight RFRs. To make this adjustment, RFRs will be compounded over the relevant IBOR period with a spread adjustment added to the compounded rate. This spread adjustment will be calculated by looking at the historic median difference between the relevant IBOR and corresponding RFR over a five-year lookback period. Importantly, this five-year period has not ended and therefore the spread adjustment is not yet known.

For example, in the event of a permanent cessation of LIBOR (where both parties have adhered to the Protocol), legacy transactions between the parties would be amended such that the relevant RFR, with its new calculation methodology and a standardised spread adjustment, would apply as the fallback rate unless the counterparties have agreed bilaterally to apply a bespoke adjustment spread prior to the cessation.

The fallback rates will be adjusted versions of the RFRs identified by working groups in each jurisdiction as alternatives to IBORs. For sterling LIBOR, the RFR will be SONIA. For the full list of the replacement RFRs please refer to the ISDA explanatory document.

Bloomberg will calculate the spread adjustments and publish an 'all-in' fallback rate through a variety of different distribution platforms. Since 21 July 2020, Bloomberg has been publishing the fallback rates on an indicative basis.

When does the conversion to adjusted RFRs occur?

The transition mechanics in both the Protocol and the Supplement (being those provisions which convert LIBOR to an adjusted RFR) are triggered upon the earlier of: (1) Cessation Day, and (2) the occurrence of a "pre-cessation" event (which would include an announcement by the FCA that LIBOR is no longer, or at a future date will no longer be, representative of the underlying market and economic reality in the relevant currency). Additionally, the Supplement and Protocol provide for fallbacks in the event that LIBOR becomes temporarily unavailable; if for example, LIBOR is not

published on a specific date due to a disruption event but no pre-cessation event has yet occurred.

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What agreements does the Protocol cover?

The documents covered by the Protocol (the "**Protocol Covered Documents**") include certain ISDA Master Agreements, Additional Master Agreements, ISDA Credit Support Documents, Additional Credit Support Documents and Confirmations, each as defined in the Protocol.

In summary, in order to be in scope, a Protocol Covered Document must:

i. be dated prior to the Effective Date, or if later, prior to the date on which all parties have adhered to the Protocol;

ii. in the case of a Confirmation, supplement or form part of a Master Agreement; and

iii. either: (a) incorporate covered ISDA definitions (such as the 2006 ISDA Definitions), or (b) reference a relevant IBOR (such as LIBOR).

For non-ISDA documents (Additional Master Agreements or Additional Credit Support Documents), the relevant document must be listed in the Additional Documents Annex of the Protocol as an 'Additional Master Agreement' or an 'Additional Credit Support Document'. A complete list of non-ISDA Master Agreements and non-ISDA Credit Support Documents that are covered by the Protocol can be found in Part 1 and Part 2 respectively of the Additional Documents Annex of the Protocol.

3 Key Considerations when adhering to the Protocol

The Protocol has been endorsed by regulatory bodies and industry groups, including the BoE, the FCA and the Financial Stability Board. The RFR WG released a joint statement with the BoE and FCA to strongly encourage early adherence to the Protocol by both financial and non-financial institutions.

However, LIBOR cessation, if improperly managed, may have adverse financial implications for market participants with LIBOR exposures. Market participants should carefully consider a number of factors before adhering to the Protocol, including:

(1) the **financial implications** of adhering to the Protocol and in particular how adjustment calculations will be applied to the relevant RFRs (as explained above);

(2) the **broad scope** of the documents covered by the Protocol (as explained above);

(3) the need to assess on a transaction-by-transaction basis whether transition, in particular the timing of transition, pursuant to the Protocol meets the adhering party's **commercial objectives** and does not have any unintended consequences (such as hardwiring a mismatch into hedging linked to cash product (discussed below)); and

(4) the Protocol's **Implementation Date**.

"Winners and losers"

ISDA's CEO Scott O'Malia noted last year that "there will be winners and losers" where there is a mismatch between the adjusted RFRs and corresponding IBORs. Market participants should be mindful of financial implications arising from any mismatch.

Parties should consider the economic impact of transition (if the adjusted RFR is less favourable than LIBOR) and the potential for basis risk (e.g. if there is a mismatch between the fallback rate of a loan and the fallback rate of any hedging of the interest rate of that loan).

The regulatory (including potential loss of grandfathering[1]), tax and accounting implications that might arise from adherence to the Protocol and the adoption of adjusted RFRs will also need careful consideration.

Facility (or other cash product) linked hedging

The mismatch risk is particularly acute where a party has entered into a hedging transaction in order to mitigate a risk arising under another financial arrangement. An example of this would be a borrower which is a party to a LIBOR referencing facility that has entered into a LIBOR referencing interest rate swap in order to hedge the interest rate component of its payment obligations to the lenders.

Should the borrower adhere to the Protocol, upon the occurrence of a pre-cessation trigger, the interest rate

[1] Grandfathering is the phrase used to describe transactions that benefit from different regulatory treatment partly as a result of the date on which they were entered into. For example, certain long dated trades under EMIR are out of scope for clearing even though *prima facie* clearing applies (partly because they were entered into before clearing was ever contemplated). It is possible for a party to lose the benefit of "grandfathering" upon the occurrence of certain transaction lifecycle events. Parties should consider whether adherence to the protocol could have such an effect.

swap would (by operation of the Protocol) automatically be converted to a fallback rate (being adjusted SONIA). However, if the interest rate under the loan agreement is not also updated, at the same time, to the same fallback rate, a mismatch between the loan and the interest rate swap will arise.

The materiality of the consequences of such a mismatch will vary depending on the particular transaction but a key issue is that the transition will result in an imperfect hedge (as the rates under the facility and the derivative will no longer match). This could adversely affect the borrower's ability to service its interest rate payment obligations under the facility and, ultimately, could cause breaches of the facility agreement. Market participants engaged in these types of transactions should consider the consequences of adherence carefully before taking further steps.

In addition, parties considering 'new' hedging transactions in connection with LIBOR referencing cash products after the Effective Date should be mindful that incorporating the Supplement into the derivatives documentation will automatically embed the fallback rates set out in the Supplement. Again, this could be inappropriate. If the cash product in question is to transition to a rate (such as the BoE base rate) other than the fallback rate in the Supplement a mismatch will arise.

Market participants should therefore consider different fallback rate calculation mechanisms carefully, calculate the impact of a rate change on their transactions and address any relevant hedging concerns resulting from any changes. It is worth noting that parties can conduct bilateral negotiations to agree how to deal with any changes to the economics of a transaction.

IMPLEMENTATION DATE

For the Protocol to be effective, each party to a Protocol Covered Document must have adhered to the Protocol. With respect to any two parties who have adhered to the Protocol, the Implementation Date is the date of acceptance by ISDA of the adherence letter from the latter of the two adhering parties.

If one of the parties to a Protocol Covered Document adheres to the Protocol after the Effective Date, the Implementation Date will be the date on which the latter of the two parties adheres to the Protocol. In these circumstances, the Implementation Date will be the date on which the Protocol applies to the Protocol Covered Documents entered into between those parties.

The Implementation Date under the IBOR Fallbacks Protocol might be specific to a particular Protocol Covered Document as there may be various Implementation Dates as between two adhering parties, particularly where an Agent (such as an investment manager) is adhering on behalf of multiple clients. This is different to the approach taken in other ISDA protocols where there is generally only one Implementation Date per relationship. Market participants should, therefore, be mindful to keep track of the relevant Implementation Dates.

4 Conclusion

The FCA and the RFR WG have set the tone for LIBOR transition. Both have advocated for market participants to adhere to the Protocol. While the Protocol is not going to be the right approach for every institution, and it remains to be seen whether certain parts of the market hold out or go for a more bespoke approach, most within the industry expect adherence to become relatively commonplace.

By design, the Protocol is well suited to the needs of counterparties looking to bulk convert a significant volume of contracts. Accordingly, it is likely to be most appealing to parties with large numbers of LIBOR referencing legacy trades (making it particularly useful for sell side institutions). These same characteristics will make adherence appealing to investment managers with large client rosters.

Prospective adherents should be mindful of the risk of unintended consequences, especially if they engage in hedging linked to cash products. The Protocol may nonetheless be an appropriate option, provided that care is taken to ensure that any potentially problematic transactions, and the agreements which govern them, are carved out from the terms of the Protocol where necessary.

In conclusion it would be fair to say that for most parties the Protocol will do what they need for most of their LIBOR referencing contracts. Despite, however, the best efforts of the draftsmen and the encouragement of the FCA and the RFR WG, the Protocol is not a one-size-fits-all solution.

5 How Travers Smith Can Help You

There are a number of ways in which we can assist you, including:

(1) assessing how the Protocol would impact your existing documentation;

(2) recommending whether Protocol adherence would be appropriate for you;

(3) negotiating and drafting the required documentation to implement bespoke LIBOR transition arrangements where full adherence is not appropriate; and

(4) advising whether the Supplement should be included in your derivatives agreements on a go forward basis.

6 Key Contacts

Should you have any questions in relation to this note, please contact one of the Derivatives & Structured Products team, or your usual Travers Smith contact.

FOR FURTHER INFORMATION, PLEASE CONTACT

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