ISDA's IBOR fallbacks go live

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Introduction

After months of consultation, the IBOR Fallbacks Supplement and Protocol (Supplement and Protocol) of the International Swaps and Derivatives Association (ISDA) entered into force on 25 January 2021. The Supplement and Protocol provide fallbacks for derivatives contracts currently referencing LIBOR and other interbank offered rates (IBORs).

These fallbacks are incorporated with immediate effect into all new derivatives agreements that incorporate the 2006 ISDA Definitions and in all legacy non-cleared derivatives where both parties have adhered to ISDA's IBOR Fallbacks Protocol.

The fallbacks cover Australia's Bank Bill Swap Rate, the Canadian Dollar Offered Rate, euro LIBOR, EURIBOR, HIBOR, the Singapore dollar Swap Offer Rate, sterling LIBOR, Swiss franc LIBOR, the Thai baht Interest Rate Fixing, TIBOR, euroyen TIBOR, yen LIBOR and US dollar LIBOR.

Although adherence to the Protocol is voluntary, the Swiss Financial Market Supervisory Authority (FINMA) recommends affected supervised institutions to sign the Fallbacks Protocol.

Background

The transition of IBORs to new alternative risk-free rates (RFRs) constitutes a historic turning point in financial markets. ISDA estimates that over USD 350 trillion of various financial instruments currently reference LIBOR, many of which do not have adequate fallback language to address its cessation.

In Switzerland, LIBOR-linked derivatives constitute the largest volume to be replaced. A survey conducted by FINMA in June 2020 revealed a cumulative volume (for all LIBOR currencies, i.e. CHF, EUR, GBP, JPY, USD) of over CHF 11.5 trillion in contracts for OTC derivatives linked to LIBOR extending beyond 2021.

With LIBOR expected to cease as of the end of 2021, banks and other financial players need to act now in order to make the LIBOR transition process as smooth as possible. ISDA's IBOR Fallbacks constitute effective means for LIBOR transition as they facilitate the multilateral amendment of legacy derivatives contracts without requiring renegotiation or adoption of fallback language in new derivatives agreements.

Mechanisms of the Supplement and Protocol

The Supplement and Protocol amend the definitions of specific 'rate options' by providing fallbacks which would apply upon the permanent cessation of key IBORs and the non-representativeness of LIBOR rates.

New trades

The Supplement amends the rate options set out in the 2006 ISDA Definitions by including fallbacks to risk-free rates in the relevant IBOR definitions. New derivative agreements incorporating the 2006 ISDA Definitions from 25 January 2021 onwards will automatically incorporate the 2006 ISDA Definitions as amended by the Supplement. The new fallbacks will apply to all derivative agreements incorporating the 2006 ISDA Definitions and entered into on or after 25 January 2021 unless the parties specifically exclude them.

Legacy trades

The Protocol allows adhering parties to incorporate the terms of the Supplement into their legacy trades with other parties that have adhered to the Protocol. The Additional Documents Annex to the Protocol even enables parties to amend additional agreements (other than ISDA Master Agreements) that reference IBORs.

Fallback rates

The Supplement and the Protocol provide fallbacks to RFRs which are adjusted to account for the difference in term and credit risk between the IBORs and the RFRs. ISDA has chosen the Bloomberg Index Service Limited to calculate and publish the adjustments to the RFRs and the 'all-in' fallback rate.

Trigger events

The fallbacks for a particular currency applies upon a permanent cessation of the IBOR in that currency. For derivatives referencing LIBOR, the fallbacks in the relevant currency also apply following a determination by the UK Financial Conduct Authority that LIBOR in that currency is no longer representative of its underlying market.

Adherence to the Protocol

There is currently no deadline for adherence to the Protocol. However, ISDA has reserved the right to designate a closing date by giving at least 30 days' notice.

Potential issues with opting out of Protocol adherence

Although adherence to the Protocol is voluntary, opting out is not risk-free. In particular, market participants opting out of adherence could face, amongst other things, potential mismatches with new contracts, potential mismatches with cleared contracts as well as a lack of existing viable fallbacks in their legacy derivatives agreements.

Going forward

Market participants that have not yet adhered to ISDA's IBOR Fallbacks Protocol should evaluate their outstanding IBOR exposure and consider whether they should adhere to the Protocol in order to reduce the risk of disruption in the event of IBOR cessation. They should further carefully consider whether blanket adherence to the Protocol is sufficient, or whether a bilateral amendment to certain trades would be more appropriate. This is because ISDA has stressed that its Fallbacks Protocol should be seen more as an 'airbag' that should only be used if necessary, with active transition still being recommended as the primary course of action.

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