ISDA® Safe, Efficient Markets

April 10, 2019

Andrew Bailey
Chief Executive Officer
UK Final Conduct Authority

John Williams
President and Chief Executive Officer
Federal Reserve Bank of New York

Co-Chairs
Official Sector Steering Group

By email

Derivative contract robustness to risks of interest rate benchmark discontinuation

Dear Mr. Bailey and Mr. Williams:

Thank you for your continued support of ISDA's work to implement more robust fallbacks for derivatives referencing key interbank offered rates (IBORs). We write to update you on the status of this work and key milestones over the next year.

After a very successful consultation on the term and spread adjustments for certain IBORs in 2018, key milestones for 2019 include supplemental consultations on term and spread adjustments for additional key IBORs, selection of a vendor to publish those adjustments, launch of amendments to the 2006 ISDA Definitions and launch of a protocol to include the amendments in existing derivative transactions. Per your recent request, we will also solicit market feedback on how derivatives market participants expect to address certain pre-cessation events related to LIBOR in particular.

Fallback Rates. ISDA expects to amend certain "Rate Options" in the 2006 ISDA Definitions to include fallbacks that would apply upon the permanent cessation of certain key IBORs. These IBORs include LIBOR in all five currencies (USD, GBP, CHF, JPY and EUR), EURIBOR, TIBOR, Euroyen TIBOR, BBSW, HIBOR and CDOR. As discussed and agreed with you, the fallbacks will be to the risk-free rate (RFRs) that have been identified for the relevant IBORs as part of global benchmark reform work. A chart setting out the fallback RFR for each of the IBORs is attached to this letter.

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Term and Spread Adjustments. In July 2018, ISDA launched a *Consultation on Certain Aspects of Fallbacks for Derivatives Referencing GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW*.[1] The consultation requested feedback on the most appropriate term and spread adjustments for fallbacks to RFRs in derivatives that currently reference IBORs. It is necessary to address these issues because the fallback RFRs are overnight and risk-free (or nearly risk-free) whereas the relevant IBORs have term structures and incorporate a bank credit risk premium and a variety of other factors (e.g., liquidity, fluctuations in supply and demand).

We were very pleased to receive responses to our July 2018 consultation from 164 entities across a variety of different types of market participants and jurisdictions. In December 2018, ISDA published the consultation results and a summary of the responses received.[2] For the covered benchmarks, the overwhelming majority of respondents preferred the "compounded setting in arrears rate" for the term adjustment, and a significant majority across different types of market participants preferred the "historical mean/median approach" for the spread adjustment. Preliminary feedback also supported using a compounded setting in arrears rate and a historical mean/median approach to the spread adjustment for other IBORs.

In April 2019, ISDA will launch a supplemental consultation covering USD LIBOR, CDOR and HIBOR. The supplemental consultation is a streamlined version of the July 2018 consultation that focuses on the compounded setting in arrears rate and the historical mean/median approach to the spread adjustment but also offers respondents the opportunity to express different preferences for these IBORs. ISDA expects to launch a similar supplemental consultation for EURIBOR and EUR LIBOR after €STR is published and traded.

ISDA is currently administering an RFP process to select a vendor that will publish the term adjusted RFR and spread adjustment for each IBOR. We expect that the vendor will begin publishing the information around the end of 2019 so that market participants have an indication on what the adjusted fallback rates would be if they were triggered. The vendor's publication will also serve as the "golden source" for the fallback rates if they are triggered, which will mitigate against counterparty disputes over calculations and increase transparency for all market participants. We are committed to ensuring fair and open access to the information published by the selected vendor.

Before implementing fallbacks in its definitions, ISDA will solicit feedback from all market participants on the final parameters for the term and spread adjustments. These include the length of the historical lookback period and whether to use a mean or a median for the historical mean/median approach to the spread adjustment. ISDA expects to consult on these issues in the summer of 2019, after selecting a vendor and analyzing the results of the April 2019 supplemental consultation covering USD LIBOR, CDOR and HIBOR.

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[1] http://assets.isda.org/media/f253b540-193/42c13663-pdf/.

[2] https://www.isda.org/2018/12/20/isda-publishes-final-results-of-benchmark-fallback-consultation/.

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Timing and Form of Amendments. As it has done from time to time, ISDA intends to amend the 2006 ISDA Definitions by publishing a 'Supplement' (or 'Supplements') to the 2006 ISDA Definitions. Upon publication of the Supplement for the relevant IBOR, all transactions incorporating the 2006 ISDA Definitions that are entered into on or after the effective date of the Supplement (*i.e.*, the date that the 2006 ISDA Definitions are amended) will include the amended rate option (*i.e.*, the rate option with the permanent cessation trigger and related fallback).

Transactions entered into prior to the effective date of the Supplement (so called 'legacy derivative contracts') will continue to be based on the 2006 ISDA Definitions as the 2006 ISDA Definitions existed before they were amended pursuant to the Supplement, and therefore will not include the amended rate option with the fallbacks. However, ISDA also expects to publish a protocol (or protocols) to facilitate multilateral amendments to include the amended rate options, and therefore the fallbacks, in legacy derivative contracts. By adhering to the protocol, market participants would agree that their legacy derivative contracts with all other adherents will include the amended rate option for the relevant IBOR and will therefore include the fallback. As always, any such protocol will be completely voluntary and will only amend contracts between two adhering parties (i.e., it will not amend contracts between an adhering party and a non-adhering party or between two non-adhering parties). Public sector support from the FSB OSSG and its members will be critical to achieving broad adherence to the protocol. In this respect, we fully support and encourage ongoing efforts to resolve issues related to the accounting treatment of derivatives that incorporate fallbacks and provide market participants with comfort that amending transactions currently exempt from clearing and margining obligations will not result in a loss of the exemptions. These issues currently represent significant threats to widespread protocol adherence and their resolution will represent key milestones.

ISDA hopes to finalize amendments to the 2006 ISDA Definitions and launch a protocol for all of the IBORs except EURIBOR and EUR LIBOR by the end of 2019. This timing remains contingent on a successful supplemental consultation on USD LIBOR, CDOR and HIBOR, publication of the spread and term adjustments by the selected vendor and approval of relevant competition law authorities globally. We expect that the amendments will take effect during the first quarter of 2020, approximately three months after they are finalized. The three-month period will allow market participants to adhere to the protocol so that the fallbacks take effect in new derivative transactions and legacy derivative transactions with other protocol adherents on the same date. At least two CCPs that clear OTC interest rate derivatives have indicated that they expect to use the discretion they have in their rulebooks to implement the fallbacks in cleared transactions as of that date as well. We are very encouraged by this development and think that broad implementation of the fallbacks in cleared derivatives will help drive implementation of the fallbacks in legacy non-cleared derivative via the protocol.

Permanent Cessation Triggers and Pre-Cessation Issues. For purposes of the fallbacks that ISDA expects to implement in the 2006 ISDA Definitions, permanent cessation will generally be defined to include a public statement that the IBOR will cease permanently or indefinitely by (1) the IBOR's administrator or (2) a public sector (or similar) official with authority over the IBOR's administrator or the central bank for the relevant currency. The date of the public statement will be relevant to the calculation of the spread adjustment but if the discontinuation is pre-announced, then the fallbacks will not take effect until the IBOR actually ceases to exist.

In response to your March 2019 letter, we will soon launch a consultation on the preferred approach for addressing pre-cessation issues in derivatives that reference LIBOR and potentially other IBORs, including in the context of a regulator's statement that the relevant IBOR is no longer representative. ISDA will use the responses to the consultation to determine what protocols or other documentation solutions would be most useful and appropriate for derivative market participants to use in addressing pre-cessation issues.

Your letter mentions pre-cessation triggers in fallback language under consideration for certain new cash products and potential regulatory implications of a benchmark becoming "non-representative". Our consultation will explain the differences in documentation and transition plans for derivatives versus cash products and how these differences may affect implementation of fallbacks, discuss the importance of aligning both new and existing hedges and describe in detail relevant legal authorities related to non-representative benchmarks. It will then ask a series of question about how derivative market participants may want to address a statement that a benchmark is no longer representative and what factors would influence how they approach such a scenario.

It will be critical that any steps ISDA takes with respect to pre-cessation issues not jeopardize marketwide adherence to the protocol described above for inclusion of permanent cessation fallbacks in existing derivatives. We look forward to discussing the consultation results with you and developing a path forward on pre-cessation issues.

Fallbacks to Term Rates. We understand that work is underway in several of the risk-free rate working groups to consider, and potentially produce, forward-looking term rates based on the RFRs. Cash market participants have strongly supported use of these forward-looking term rates as fallbacks for cash products referencing the relevant IBORs (assuming the rates exist upon triggering of the fallbacks).

Consistent with the 2018 guidance from the FSB OSSG that derivatives generally should not reference forward-looking term rates, ISDA is implementing fallbacks based on the actual RFRs. We understand and agree that a robust derivatives market in the RFRs themselves is a predicate to forward-looking term rates and therefore understand the issues associated with using a forward-looking term rate as the fallback for the broader derivatives market.

We are concerned that some market participants may interpret statements from the risk-free rate working groups supporting fallbacks to forward-looking term rates as inconsistent with ISDA's work because the statements could be read to cover derivatives generally in addition to cash products or derivatives that are used to hedge such cash products. We encourage the FSB OSSG, its members and the risk-free rate working groups to continue to provide clear and coherent messaging on this issue in order to reduce the potential for confusion among market participants. Such confusion could jeopardize uptake of the fallbacks ISDA expects to implement for derivatives and fragment the derivatives market. Among other things, it is important for market participants to understand that the forward-looking term rates do not yet exist and may not exist for some time.

Related Benchmark Reform Initiatives. ISDA supports the work of the FSB OSSG, its members and the risk-free rate working groups to reduce risks associated with LIBOR and other IBORs and transition towards the alternative RFRs. We note that this work is multi-faceted and we look forward to working with our members and the public sector to address issues related to regulatory margin, capital, tax, accounting and collateral in order to ensure broad market adoption of RFRs and implementation of robust fallbacks.

Please do not hesitate to reach out if you have any questions.

Sincerely,

Scott O'Malia	Katherine Tew Darras
Chief Executive Officer	General Counsel

Relevant IBOR and corresponding floating rate options in 2006 ISDA Definitions		Fallback Rate	Administrator of Fallback Rate
GBP LIBOR	GBP-LIBOR-BBA GBP-LIBOR-BBA-Bloomberg	SONIA	Bank of England
CHF LIBOR	CHF-LIBOR-BBA CHF-LIBOR-BBA-Bloomberg	SARON	SIX Swiss Exchange
JPY LIBOR	JPY-LIBOR-FRASETT JPY-LIBOR-BBA JPY-LIBOR-BBA-Bloomberg	TONA	Bank of Japan
TIBOR	JPY-TIBOR-TIBM JPY-TIBOR-17096 JPY-TIBOR-17097 JPY-TIBOR-TIBM (All Banks)-Bloomberg	TONA	Bank of Japan
Euroyen TIBOR	JPY-TIBOR-ZTIBOR	TONA	Bank of Japan
BBSW	AUD-BBR-AUBBSW AUD-BBR-BBSW AUD-BBR-BBSW-Bloomberg	RBA Cash Rate	Reserve Bank of Australia
USD LIBOR	USD-LIBOR-BBA USD-LIBOR-BBA-Bloomberg USD-LIBOR-LIBO	SOFR	Federal Reserve Bank of New York
HIBOR	HKD-HIBOR-HKAB HKD-HIBOR-HKAB-Bloomberg	Adjusted HONIA [Note that Adjustments still	Treasury Markets Association

		subject to work within HKMA]	
CDOR	CAD-BA-CDOR CAD-BA-CDOR-Bloomberg	CORRA	Thomson Reuters
EUR LIBOR	EUR-LIBOR-BBA EUR-LIBOR-BBA-Bloomberg	€STER	European Central Bank
EURIBOR	EUR-EURIBOR-Reuters	€STER	European Central Bank

Timeline for Implementation of IBOR Fallbacks[3]

1. ISDA to produce description of methodology for adjustments and questions regarding open issues – January-July 2019

    - ISDA Benchmark Working Groups (as well as external experts) to comment on and discuss technical issues associated with the "compounded setting in arrears rate"
    - ISDA to work with The Brattle Group and other external experts to analyze and perform sensitivity analysis on the "historical mean/median approach" to the spread adjustment (without input from ISDA working groups or market participants during this time period given the sensitivity of the parameters)
    - Vendor that will publish adjustments to provide feedback once selected

2. Public sector antitrust/competition review of calculation methodology to be implemented (e.g., US Department of Justice business review letter process) – January-[September/December], 2019

3. Selection of vendor to publish adjustments – February-May 2019

4. **Publication of supplemental consultation for USD LIBOR, HIBOR and CDOR – April 2019**
    - **8 week comment period**

5. **Publication of request for market feedback on pre-cessation issues and related documentation solutions for derivatives –April 2019**
    - **8 week comments period**

6. **Publication of complete methodology to be implemented and questions regarding open issues for public review and comment – July 2019**
    - **4-6 week comment period**

7. Vendor build – August-[September/December] 2019

8. Market participant infrastructure build (including CCPs) – August-[September/December] 2019

9. Finalize amendments to the 2006 ISDA Definitions and protocol to include the amended definitions in existing transactions –August-September 2019 (based on framework circulated in December 2018 and discussed throughout the first half of 2019)

[3] Unless otherwise noted, all dates apply to GBP LIBOR, CHF LIBOR, JPY LIBOR, USD LIBOR, TIBOR, Euroyen TIBOR, BBSW, CDOR and HIBOR.

10. Expected launch of final amendments to the 2006 ISDA Definitions and protocol – September-December 2019

    - Release expected approximately two weeks after completion of vendor build
    - Effective date of amendments and protocol will be approximately three months after release (adherence to the protocol will be open during this period)

11. **Publication of supplemental consultation for EUR LIBOR and EURIBOR – TBD after publication of ESTER**
    - **Expected to cover all aspects of spread and term adjustments**
    - **Approximately 8 week comment period**

12. Finalize amendments to the 2006 ISDA Definitions for EUR LIBOR and EURIBOR and protocol (or annex to protocol described above) to include the amended definitions in existing transactions – TBD after supplemental consultation and related vendor/market participant infrastructure build (based on framework circulated in December 2018)