HEDGE FUND LAW: ARTICLE SERIES

The End of IBOR

ISDA IBOR Fallbacks Protocol and Solutions for Managers

Poseidon Retsinas and David Balass
October 26th, 2020

Introduction

The financial world is moving on from Interbank Offered Rates ("**IBORs**"). At the advice of regulators and industry groups, all firms with financial products linked to these ubiquitous sets of interest rate benchmarks—the most popular of which are the London Interbank Offered Rate ("**LIBOR**") and the Euro Interbank Offered Rate ("**EURIBOR**")—will have to undergo a transition to alternative benchmarks, namely to Overnight Risk Free Rates ("**RFRs**"). This transition is scheduled to be phased-in by the end of 2021—at which point the ever-familiar IBOR will expire for good.

Considering that roughly US$240 trillion in notional volumes is linked to IBOR[1], there is ample work to be done in the interim; the transition away from IBOR represents one of the chief undertakings of the financial sector for the years to come.

With respect to derivatives, surveys of market participants on both buy-side and sell-side have indicated that derivatives products present the greatest level of difficulty when it comes to the transition to RFRs.[2] The International Swaps and

[1] See Paul Cantwell et al., "Changing the World's Most Important Number: LIBOR Transition" (Feb 2020), Oliver Wyman, online: https://www.oliverwyman.com/content/dam/oliver-wyman/v2/publications/2018/February/LIBOR-transition-POV-FINAL.pdf

[2] In a Risk.net survey commissioned by KPMG, derivatives products were compared to syndicated loans, mortgages, bi-lateral loans, floating-rate notes, and securitizations. See Risk.net, "Letting go of Libor: How banks and buy-side firms are navigating the road to transition" (06 Aug 2020), online:

Derivatives Association ("**ISDA**") has been working for many months on finding consensus among the financial community and regulators. ISDA announced its solution on October 9, 2020, which will be implemented via the IBOR Fallbacks Supplement to the 2006 ISDA Definitions ("**Fallbacks Supplement**") and the ISDA 2020 IBOR Fallbacks Protocol ("**Fallbacks Protocol**").

With that, there is no better time than now for managers to lay the groundwork necessary to smoothly handle the transition and manage its impact on derivatives contracts, systems, and models.

This article will begin with a brief description of IBOR and its current uses in the financial sector. It will highlight what challenges the transition away from IBORs poses to managers and explore the solution proposed by ISDA. Finally, the article will conclude with a framework for managers to approach the transition going forward.

---

https://www.risklibrary.net/risk-management/letting-go-libor-evolving-transition-strategies-110-banks-and-buy-side-firms-30381

What is IBOR?

IBOR is the dominant benchmark interest rate used in financial contracts. As indicated in the name, IBORs are determined based on the interest rates at which banks are willing to lend and borrow from one another on an unsecured basis in a particular currency.[3] IBOR is also used to price numerous products such as syndicated loans, bilateral loans, letters of credit, private placements, floating rate notes, and securitizations. In addition, IBOR is used in derivatives products (e.g., forwards, swaps, and options) for pricing purposes and/or to determine the payment obligations of each party.

IBOR Use by Managers

Fund managers use IBOR as a benchmark interest rate for derivatives transactions and often also as a performance target. IBORs are also deployed as inputs into various calculations, systems, and models—for instance, in valuation and risk models.

Why This is Important for Managers

Since IBORs are closely linked to trading strategies and exposure which managers currently have in place, the discontinuation of IBOR presents a challenge in that transactions will need to be updated and models changed to reflect the replacement RFRs. This must occur prior to IBORs ultimate cessation by the end of 2021.

For instance, equity swaps or portfolio swaps usually also reference an IBOR plus a spread; these will need to be amended, which could involve bilateral negotiation or discussion. It could also be resolved by adherence to the Fallbacks Protocol.

If managers do not take action, transactions and contractual arrangements referencing IBORs may cease to function as intended and will create contractual and portfolio-related issues.

Another impact for managers that we would like to highlight, although outside the scope of this article and ISDAs efforts with respect to derivatives, is manager performance fees. Performance fees will be affected because hurdle rates and other benchmark calculations are often based on an IBOR plus a spread. The SEC has stated that managers must be fair in determining new rates that are properly representative.

Why the Transition to RFRs is a Challenge

The transition to RFRs is a challenge primarily because RFRs do not operate in the same way that IBORs do. Although ISDA and other industry organizations, such as Bloomberg, have worked for years to develop RFRs that would as closely as possible resemble their outgoing IBORs, they simply are not the same. RFRs therefore need to be adjusted to become better approximations of the IBORs. Here are the key differences:

Term vs Overnight

IBORs are term rates whereas RFRs are overnight rates. As such, the RFR must be adjusted to replicate this term element. This is achieved by looking back in time at

[3] Some examples in the 2006 Definitions of IBORs being replaced are: USD-LIBOR-BBA, GBP-LIBOR-BBA, EUR-LIBOR-BBA, EUR-EURIBOR-REUTERS. For a table of IBORs and their alternative RFRs, see ISDA, “Benchmark Reform and Transition from Libor” (updated on a regular basis), online: https://www.isda.org/2020/05/11/benchmark-reform-and-transition-from-libor/.

the RFR for the same period of time as the term of the IBOR and then compounding this.[4] For instance, to replace a 3-month IBOR, the overnight rate of the RFR would be looked back over the last 3 months and compounded.

An important consequence of this difference is that IBORs are forward-looking rates and so their rate is known at the beginning of a Calculation Period in a swap. Since RFRs require a lookback and compounding on each day, the rate changes over time, and so for Floating Payments on swaps, the amount of the payment will not be known until the end of the Calculation Period.

IBORs Reflect Liquidity and Creditworthiness of the Borrower

Another difference is that IBORs reflect the liquidity and the creditworthiness of the borrower (recall that these are interbank offered rates). As such, RFRs must be adjusted for a "spread" element which is calculated by using data showing the difference between the IBOR and the RFR over the past five years – the lookback period.

"Although ISDA and other industry organizations, such as Bloomberg, have worked for years to develop RFRs that would as closely as possible resemble their outgoing IBORs, they simply are not the same."

[4] See Bloomberg, ISDA and Linklaters, "Fact Sheet: IBOR Fallbacks" (June 2020), which reviews the adjustments in detail and provides examples (p. 11). online:http://assets.isda.org/media/d3cb1711/42ca5ad8-pdf/

ISDA IBOR Fallbacks Protocol and Fallback Supplement

As mentioned in the introduction, ISDA has been working for many months to find a solution that will gain market-wide approval and adoption.

The objective for ISDA has been twofold:

(i) updating its 2006 Definitions booklet to introduce fallback rates (i.e. RFRs) to IBORs which are still in use and which will be terminated at some point in the future – this is being implemented through the Fallbacks Supplement; and

(ii) finding an effective means of allowing users of derivatives to amend existing derivatives referencing IBORs (i.e., legacy contracts) – this is being implemented through the Fallbacks Protocol.

Fallbacks Supplement

The Fallbacks Supplement will apply to new derivatives transactions entered into after January 25th, 2021 that reference the 2006 ISDA Definitions. So, in a sense, the Fallbacks Supplement is intended to address and cover all new transactions entered into after January 25, 2021. Parties entering into transactions after that date should be aware of this and take it into account. Where possible, transactions referencing IBORs should be avoided.

The Fallbacks Supplement specifies the fallback RFRs ("**Fallback Rates**") which apply in the event that an IBOR is no longer available (i.e., an Index Cessation Event).[5] For instance, for USD LIBOR, the Fallback Rate is Secured Overnight Financing Rate (SOFR). The Fallbacks Supplement also caters to situations where the IBOR is not being published on a temporary basis, or where the Fallback Rate itself is not available.

The Fallback Rates will be calculated and published by Bloomberg. Bloomberg, ISDA and Linklaters have prepared an informative factsheet reviewing the Fallback Rates and adjustments.

Importantly, the Fallbacks Supplement does not itself replace rates in any transactions, unless the IBOR is no longer available.

Please see Annex I hereto with a list of IBORs and their corresponding Fallback Rates.

From a legal documentation perspective, the more challenging area will be amending legacy transactions which were entered into prior to January 25, 2021 that reference IBORs and are expected to have maturities past the cessation of the relevant IBOR. For those transactions, ISDA has developed the Fallbacks Protocol.

ISDA Fallbacks Protocol

The Fallbacks Protocol, similar to other ISDA protocols that came before it, is a means for users of derivatives to amend agreements covered by the protocol across all its counterparties. Where two or more parties have adhered to the protocol, their

[5] See ISDA, "Amendments to the 2006 ISDA definitions to include new IBOR fallbacks", full text of Fallbacks Supplement, online: http://assets.isda.org/media/3062e7b4/23aa1658-pdf/.

agreements are deemed to be amended by the provisions of the protocol.

In the case of the Fallbacks Protocol, the purpose of this amendment is to incorporate the Fallbacks Supplement in the documentation of adhering parties.[6]

Generally, ISDA Protocols only serve to amend ISDA documentation, but the Fallbacks Protocol will also amend other agreements, such as MRAs, GMRAs, GMSLAs, etc.[7]

When is it available/effective?

On October 23rd, 2020, ISDA launched the Fallbacks Protocol, which will become effective on January 25th, 2021. This means that any adherence to the Fallbacks Protocol will become effective and amend protocol covered by agreements after January 25th, 2021.

ISDA has not announced any closing date for adherence to the protocol, and so managers and other market participants can wait until after January 25th, 2021 to adhere.

Should Managers Adhere?

Per ISDA, Fallback Rates are not intended to be a primary means of moving from IBORs to RFRs.[8] They are there as a backstop, and market participants should seek to voluntarily amend or close out any contracts which refence IBORs.

Moreover, recall that RFRs are not a perfect match to the outgoing IBORs. As such, blind adherence to the Fallbacks Protocol is ill-advised. Managers should assess their IBOR exposure and the impact of moving to Fallback Rates. Where these are not a good fit, bi-lateral amendments and negotiations should be sought to address concerns and update accordingly. Managers should be proactive in conducting this assessment and opening a dialogue with affected counterparties as soon as possible. As with other regulatory changes, there will be a rush to complete as we approach the 2021 year-end deadline.

Must a Manager adhere to the protocol to incorporate it into its documentation?

No, as an alternative to adhering to a protocol, parties could apply the Fallbacks Protocol via bi-lateral amendment. ISDA has created templates that can be used in different circumstances such as excluding some agreements or transactions that would normally be covered, or including agreements that would normally not be covered.[9]

"Per ISDA, Fallback Rates are not intended to be a primary means of moving from IBORs to RFRs."

---

6 See ISDA, "Amendments to the 2006 ISDA definitions to include new IBOR fallbacks", full text of Fallbacks Supplement, online: http://assets.isda.org/media/3062e7b4/23aa1658-pdf/.

7 See ISDA, "Amendments to the 2006 ISDA definitions to include new IBOR fallbacks", full list of documentation in scope (p.23), online: http://assets.isda.org/media/3062e7b4/23aa1658-pdf/.

8 "Once the fallbacks are in place, it is recommended that market participants focus on voluntary transition before the cessation of any key IBOR. Moving away from key IBORs voluntarily by amending or closing out contracts that reference those rates allows counterparties to tailor their strategies to their specific portfolios, and could allow firms to negotiate terms that avoid the adjustment mechanisms for fallbacks." See ISDA, "Understanding IBOR Benchmark Fallbacks", online: https://www.isda.org/a/YZQTE/Understanding-Benchmarks-Factsheet.pdf).

9 See ISDA, "Bilateral Forms for IBOR Fallbacks", online: http://assets.isda.org/media/79487fdd/.

Key steps for Managers

This section highlights the most important action items for managers tasked with the IBOR transition.

Appoint Officer to Head the IBOR Transition

This officer should regularly keep up-to-date with news relating to the transition and ensure that the firm is taking appropriate measures. Moreover, the officer should be responsible for the following steps outlined below.

Evaluate Impact of Transition on Existing Contracts

The appointed officer should organize a comprehensive evaluation of the firm's exposure to IBOR. The focus should be on making methodical transitions to RFRs in all new financial contracts entered into by the various departments of the firm. When it comes to legacy contracts (i.e., those with expiries after that of IBOR), the officer should continually monitor these exposures and ensure that (i) draft fallback language to RFRs is inserted – this can either be done via adherence to the Fallbacks Protocol or by entering into ISDA template bi-lateral amendments with counterparties or (ii) the outgoing IBOR rates are replaced in advance of any cessation of the relevant IBOR.

Managers should engage in discussion with their counterparties where legacy IBOR related derivatives exist.

Develop Framework for Approaching the Transition and Disseminate Internally

It is useful to develop a firm-wide framework for approaching the IBOR transition. Exposures can vary across the firm, from its ubiquity in financial contracts, to its use in valuation and risk models. The officer in charge of the IBOR transition should communicate with the various teams and provide regular updates about the ongoing exposures to systems and contracts that are directly linked to IBOR.

"Managers should engage in discussion with their counterparties where legacy IBOR related derivatives exist."

Conclusion

It is critical that managers act now. Things are changing quickly, and we are already seeing investors, regulators, boards, and banks pressuring firms to be adequately prepared for the transition. The Office of Compliance Inspections and Examinations of the SEC announced in June 2020 an examination initiative with respect to "LIBOR Transition Preparedness" and provided a list of requests which it may send to managers.[10]

The Fallbacks Protocol, however effective it may be, is not a complete solution and should not replace a coherent strategy of how to handle the transition. Managers affected by the transition should be prudent in their adherence to the Fallbacks Protocol and adopt a careful and coherent strategy that considers all legal implications of the transition on their portfolio and operations.

[10] See United States Securities and Exchange Commission, "Examination Initiative: LIBOR Transition Preparedness", (18 Jun 2020), online: https://www.sec.gov/files/Risk%20Alert%20-%20OCIE%20LIBOR%20Initiative.pdf.

Annex 1

Currency	Relevant IBOR and Rate Options	Underlying Rate for Fallback Rate
GBP	**Sterling LIBOR** GBP-LIBOR-BBA; GBP-LIBOR-BBA-Bloomberg	Reformed SONIA
CHF	**Swiss Franc LIBOR** CHF-LIBOR-BBA; CHF-LIBOR-BBA-Bloomberg	SARON
USD	**U.S. Dollar LIBOR** USD-LIBOR-BBA; USD-LIBOR-BBA-Bloomberg	SOFR
EUR	**EUR LIBOR and EURIBOR** EUR-LIBOR-BBA; EUR-LIBOR-BBA-Bloomberg; EUR-EURIBOR-Reuters	€STR
JPY	**JPY LIBOR, Yen TIBOR and Euroyen TIBOR** JPY-LIBOR-FRASETT; JPY-LIBOR-BBA; JPY-LIBOR-BBA-Bloomberg; JPY-TIBOR-17097; JPY-TIBOR-TIBM (All Banks)-Bloomberg; JPY-TIBOR-ZTIBOR	TONA
AUD	**BBSW** AUD-BBR-AUBBSW; AUD-BBR-BBSW; AUD-BBR-BBSW-Bloomberg	AONIA
CAD	**CDOR** CAD-BA-CDOR; CAD-BA-CDOR-Bloomberg	CORRA
HKD	**HIBOR** HKD-HIBOR-HKAB; HKD-HIBOR-HKAB-Bloomberg	HONIA
SGD	**SOR** SGD-SOR-VWAP	Fallback to be based on USD/SGD FX transactions and SOFR
THB	**THBFIX** THB-THBFIX-Reuters	Fallback to be based on USD/THB FX transactions and SOFR

Source: ISDA: IBOR Fallbacks: Supplement and Protocol. October 15, 2020. Online: https://www.youtube.com/watch?v=c1rs41skg_U

Contact

Poseidon Retsinas

Founder & CEO, HedgeLegal

Poseidon.Retsinas@hedgelegal.com

www.HedgeLegal.com

Alexander Robinson

Legal Counsel

Alexander.Robinson@hedgelegal.com

www.HedgeLegal.com

About the Firm

HedgeLegal is a boutique law firm dedicated to providing hedge fund managers with industry best practice trading document negotiation. HedgeLegal has extensive experience negotiating a wide array of trading agreements: Prime Brokerage, Term Commitment/Lock-Up, ISDA, Equity Master Confirmation Agreements, Futures Clearing, OTC Clearing, FX PB, Repo, Custody, etc.

For more information, please visit http://www.hedgelegal.com or contact info@hedgelegal.com. Subscribe to our mailing list at https://hedgelegal.com/publications/.

This article has been prepared for informational purposes only and does not constitute legal advice. This information is not intended to create, and the receipt of it does not constitute, a lawyer-client relationship. Readers should not act upon this without seeking advice from professional advisers.

©2020 Hedge Legal Inc. All rights reserved