Baker McKenzie.

ISDA 2020 IBOR Fallbacks Protocol and ISDA 2020 IBOR Fallbacks Supplement

The next phase of IBOR transition begins for the derivatives market

Summary

On 23 October 2020, ISDA launched the ISDA 2020 IBOR Fallbacks Protocol (the ***IBOR Protocol***) and the ISDA 2020 IBOR Fallbacks Supplement to the 2006 ISDA Definitions (the ***IBOR Supplement***).

New RFRs

The IBOR Protocol and IBOR Supplement specify the new risk-free rates (***RFRs***) that will apply as fallbacks for certain key existing Inter-Bank Offered Rates (***IBORs***)[1] upon either the permanent cessation of such IBORs (***a permanent cessation trigger***), or, in the case of any London Inter-Bank Offered Rate (***LIBOR***), a determination by the UK Financial Conduct Authority (***FCA***) that such rate is no longer representative of its underlying market and the financial reality it is intended to measure (***a pre-cessation trigger***).

The IBOR Protocol and the IBOR Supplement provide that each new RFR will be determined on the basis of a rate derived from the corresponding overnight RFR recommended by a public/private sector working group as an alternative for the relevant existing IBOR, which is compounded in arrears over an accrual period corresponding to the tenor of such IBOR and to which a spread adjustment is applied. The spread adjustment will be published by Bloomberg and will be calculated as the median value of the basis between the relevant existing IBOR and the relevant new RFR for the corresponding tenor over a 5-year lookback period from the date of the permanent cessation trigger or pre-cessation trigger (as applicable).

[1] The IBOR Protocol and the IBOR Supplement address the fallbacks that will apply to the following IBORs: (i) LIBOR (for each LIBOR currency: Sterling LIBOR, U.S. Dollar LIBOR, Euro LIBOR, Swiss Franc LIBOR and Yen LIBOR); (ii) EURIBOR; (iii) Yen TIBOR; (iv) Euroyen TIBOR; (v) Australian BBSW; (vi) Canadian CDOR; and (vii) Hong Kong HIBOR. In addition, as USD LIBOR is used as an input for Thai THBFIX and Singapore SOR, these rates are also within the scope of the IBOR Protocol and the IBOR Supplement.

The IBOR Supplement: Derivative Transactions entered into on or after 25 January 2021

Under the terms of the IBOR Supplement, new derivative transactions entered into on or after 25 January 2021 that incorporate the 2006 ISDA Definitions will include the new RFRs.

Firms should be aware that ISDA is currently working on the 2021 ISDA Interest Rate Definitions which will include the new RFRs.

The IBOR Protocol: Legacy Derivative Transactions

By adhering to the IBOR Protocol, a party agrees to amend its legacy derivative transactions with other IBOR Protocol adhering parties in order to include the new RFRs.

The IBOR Protocol is currently open for adherence but will only take effect from the later of 25 January 2021 or the date on which both parties to the relevant derivative transaction effectively adhere to the IBOR Protocol. Any firm may adhere to the IBOR Protocol, regardless of whether it is an ISDA member. The IBOR Protocol will remain open for adherence after 25 January 2021.

Bilateral Amendments

In addition, ISDA has published a series of template amendment agreements which can be used by parties to amend their legacy derivative transactions in a bespoke manner.

Key Points to Note

- **Timing of Transition to new RFRs:** Under the terms of the IBOR Protocol and the IBOR Supplement, the transition to the relevant new RFR from the relevant existing IBOR will occur in the event of either a permanent cessation trigger, or, in the case of any LIBOR, a pre-cessation trigger. Therefore, where a permanent cessation trigger or a pre-cessation trigger (as applicable) occurs on Day 1 and it is announced that the relevant existing IBOR will cease to be published (in the case of a permanent cessation trigger) or that the relevant LIBOR will become non-representative (in the case of a pre-cessation trigger) on Day 30, the new RFR for such IBOR or such LIBOR (as applicable) will only apply as of Day 30. Firms should be aware that the transition to the new RFRs may occur at different times in respect of different existing IBORs. The IBOR Protocol and the IBOR Supplement also address circumstances where only certain tenors of an existing IBOR become subject to a permanent cessation trigger, or, in the case of any LIBOR, a pre-cessation trigger (whilst shorter or longer tenors of such IBOR continue to be available or representative (as applicable)).
- **Key Differences between existing IBORs and new RFRs:** There are inherent structural differences between the existing IBORs and new RFRs. The existing IBORs are forward-looking and available in multiple tenors, while the new RFRs are based on overnight rates that are subject to term and spread adjustments and determined at the end (rather than at the beginning) of the relevant interest calculation periods, with backward shifts applied in order that amounts payable can be calculated in sufficient time before payments are due. As such, firms should consider whether additional changes will be required to other terms in their derivative transactions in order to continue to meet the original commercial objectives to the maximum extent possible once a new RFR takes effect. Further, the new RFRs specified in the IBOR Protocol and the IBOR Supplement may not be suitable for all types of derivative transactions (for example, certain non-linear products) and a bilateral solution may be more appropriate in these circumstances.
- **Timing for Calculation of Spread Adjustment:** Upon the occurrence of a permanent cessation trigger or pre-cessation trigger (as applicable) in respect of an existing IBOR, the spread adjustment for the relevant new RFR will be "fixed" and calculated as the median value of the basis between the relevant existing IBOR and the relevant new RFR for the corresponding tenor for the five-year period up until the date of

permanent cessation trigger or pre-cessation trigger (as applicable). This spread adjustment will be published by Bloomberg on the date of the relevant permanent cessation trigger or pre-cessation trigger (as applicable) and will be used when the new RFR takes effect. If more than one permanent cessation trigger or pre-cessation trigger occurs, the IBOR Protocol and IBOR Supplement provide that the spread adjustment will be "fixed" on the date of the *first* public statement or publication of information which constitutes a permanent cessation trigger or pre-cessation trigger (as applicable). Although the calculation methodology is prescribed in the IBOR Protocol and the IBOR Supplement, the actual spread adjustments that will apply to the new RFRs are therefore currently unknown. Firms with derivative transactions that refer to, for example, LIBOR should consider whether to adhere to the IBOR Protocol in advance of a pre-cessation trigger (which is anticipated to be in early 2021) or to only adhere after the date for the calculation of the spread adjustment for the relevant new RFR has been "fixed".

- **Potential Mismatch with Related Finance Documents:** The new RFRs specified in the IBOR Protocol and IBOR Supplement may not be suitable for derivative transactions that are closely linked to underlying finance arrangements (relating to, for example, loans, bonds or other products) and have been entered into for hedging purposes. Firms should identify any potential mismatches and consider whether it would be appropriate to document matching fallbacks (and triggers) across the entire transaction at the same time, in order to ensure that such fallbacks (and the transition to the same) are aligned.
- **Cleared Derivative Transactions:** The IBOR Protocol does not amend documentation governing cleared derivative transactions. Firms should consider the rule books of the relevant central counterparty (***CCP***) to understand the potential impact on their cleared derivative transactions. CCPs have indicated that they intend to update their rule books to include the new RFRs specified in the IBOR Supplement and to update their legacy cleared derivatives transactions accordingly.
- **Non-ISDA Documentation:** The IBOR Protocol also amends a wide range of non-ISDA master agreements and non-ISDA credit support documents to include the new RFRs, as listed in the Annex to the IBOR Protocol. This list includes non-ISDA documentation governing products that are not derivative transactions (such as, for example, the Global Master Repurchase Agreement and the Global Master Securities Lending Agreement).

IBOR Protocol or Bilateral Amendments?

In respect of their legacy derivative transactions, firms should consider whether they wish to adhere to the IBOR Protocol or to amend such legacy derivative transactions on a bilateral basis. It is possible to adopt a hybrid approach, with adherence to the IBOR Protocol for all legacy derivative transactions and separate bilateral agreements, for example, to vary the scope and/or effect of the IBOR Protocol for the purposes of excluding certain products that would otherwise be covered. Firms may also use bilateral agreements to incorporate the amendments of the IBOR Protocol into their legacy derivative transactions with certain modifications (without adhering to the IBOR Protocol).

The bilateral approach is likely to be particularly helpful in circumstances where the new RFRs may not be appropriate or desirable, for example, if: (i) there is a mismatch between the new RFRs and the applicable fallbacks agreed across different documents on a related transaction; (ii) there are restrictions on amending derivative transactions entered into in support of underlying instruments or third party consents are required; or (iii) parties would like to exclude certain of their non-ISDA documentation from the scope of the IBOR Protocol.

Next Steps

Firms should familiarise themselves with the new RFRs specified in the IBOR Protocol and the IBOR Supplement and complete a due diligence examination of their relevant derivatives documentation in order to identify which of their derivative transactions will require amendment, as well as any potential exposures or mismatches.

In particular, firms should liaise with their counterparties as appropriate and consider whether they will elect to adhere to the IBOR Protocol and/or to amend their relevant legacy derivative transactions on a bilateral basis. Firms should also consider whether they will use the IBOR Supplement for new derivative transactions going forward.

Firms may also be required to update existing operational processes, or to establish new operational processes, in connection with the new RFRs (or any other fallbacks that are bilaterally agreed).

Your contacts

Matthew Dening
Partner | London
matthew.dening
@bakemckenzie.com
+44 20 7919 1818

Iris Barsan
Counsel | Paris
iris.barsan
@bakermckenzie.com
+33 1 44 17 59 41

Iolie Calochristos
Senior Associate | London
Iolie.calochristos
@bakermckenzie.com
+44 20 7919 1019

Karl Egbert
Partner | New York
karl.egbert
@bakermckenzie.com
+1 212 626 4649

Teresa Ientile
Special Counsel | Sydney
teresa.ientile
@bakermckenzie.com
+61 2 8922 5412

Seiji Matsuzoe
Partner | Tokyo
seiji.matsuzoe
@bakermckenzie.com
+81 3 6271 9440

Duncan McGrath
Partner | Sydney
duncan.mcgrath
@bakermckenzie.com
+61 2 8922 5108

Corinne Schot
Partner | Amsterdam
corinne.schot
@bakermckenzie.com
+31 20 551 7415

Ansgar Schott
Partner | Zurich
ansgar.schott
@bakermckenzie.com
+41 44 384 12 51

Baker McKenzie helps clients overcome the challenges of competing in the global economy.

We solve complex legal problems across borders and practice areas. Our unique culture, developed over 70 years, enables our 13,000 people to understand local markets and navigate multiple jurisdictions, working together as trusted colleagues and friends to instill confidence in our clients.

bakermckenzie.com