ISDA Safe, Efficient Markets

The Path Forward for LIBOR
Transcript[1] of Webinar, December 4, 2020

Moderator: Scott O'Malia, Chief Executive, ISDA

Earlier this week, ICE Benchmark Administration (IBA), the administrator of LIBOR, announced that it will consult on its intention to cease publication of one-week and two-month US dollar LIBOR at end-December 2021, and stop the remaining US dollar LIBOR settings immediately after publication on June 30, 2023. This followed an announcement on November 18 that IBA will consult on its plan to cease publication of all sterling, euro, Swiss franc and yen LIBOR settings at end-December 2021.

Alongside the November 30 release from IBA, the Federal Reserve Board published a statement welcoming the development and encouraging banks to cease using US dollar LIBOR as soon as practicable, and in any event no later than the end of 2021. This was matched by a similar release from the UK Financial Conduct Authority (FCA), which set out some information about its proposed powers under the Financial Services Bill.

Since then, there's been a lot of talk among market participants about how this will play out and what it means. Given more than 1,500 entities have now adhered to the ISDA IBOR Fallbacks Protocol, there have also understandably been questions about the implications under the fallback calculation methodology.

On this video, we'll try and answer some of those questions.

I'm delighted to be joined by:

- David Bowman, Senior Associate Director at the Federal Reserve Board
- Edwin Schooling Latter, Director, Markets and Wholesale Policy, at the FCA
- Deepak Sitlani, Partner at Linklaters
- Tom Wipf, Vice Chairman of Institutional Securities, Morgan Stanley, Chairman of the Alternative Reference Rates Committee (ARRC), and ISDA Board Member

Edwin, can you recap for us briefly the key points of the IBA and FCA announcements on November 18 and November 30?

IBA announced to the market its intention to consult on the cessation of all LIBOR currency and tenor settings on specified dates. It said there will be a single consultation covering all of them – which I anticipate will be published relatively soon – and said the consultation will close by the end of January.

IBA intends to consult on an end-2021 cessation for sterling, yen, Swiss franc, euro, and two of the lesser-used US dollar LIBOR settings, and an end-June 2023 stop for the remaining US dollar settings.

[1] This is an edited transcript of the video, and may not completely match what was said

IBA noted that, after the feedback period has closed, it will publish a feedback statement and relevant determinations resulting from the consultation.

The FCA made simultaneous statements.

In the context of IBA's proposals for a wind down of LIBOR, and the powers that the UK government has proposed to confer upon the FCA to help ensure such a wind down is orderly, we set out our current thinking on how we might use those proposed new powers – subject, of course, to consultation. Key points included:

- Proposals on the framework under which, and circumstances in which, we might consider it desirable and feasible to require continued publication of any LIBOR currency tenors on the basis of a changed methodology (this is what the market generally refers to as 'synthetic' LIBOR).
- We said that if we were to apply the proposed framework given the facts as we know them currently, we didn't think those circumstances would exist for euro or Swiss franc LIBOR, or indeed lesser-used tenors in any currencies, but it appears they would likely exist for the more commonly used sterling settings.
- We noted we would continue to assess whether they might exist for more heavily used yen and US dollar settings, depending on transition progress.

As you all know, the 20 LIBOR panel banks agreed back in 2017 to continue contributing to LIBOR until end-2021. This was so the market would have a four-and-a-half-year period to transition away from LIBOR, while remaining confident that LIBOR would continue to be published in a representative manner throughout that period. That agreement remains in place.

The FCA also welcomed and supported Monday November 30's proposal for a further 18-month extension of the US dollar LIBOR panel, to end-June 2023, following discussion with the US dollar LIBOR panel banks. This gives a further 18-month period to allow legacy US dollar LIBOR contracts to run off, but, again, we think with confidence that the rate will be published on a representative basis until that proposed end date.

One intention of our discussions with panel banks, both in 2017 and in recent weeks, was to achieve collective confidence that a sufficiently strong panel and representative rate could be maintained until an orderly end date for the panel.

Edwin, will the consultation on proposed end-dates for LIBOR cover all five currencies, and what does that mean for the timing of future announcements?

The consultation will cover all five currencies and will close by the end of January. This should make it possible to determine and make announcements on the future path for all five currencies simultaneously, even if the proposed cessation date is different – end-Dec 2021 for four currencies, and end-June 2023 for some US dollar settings. I think everyone's aim will be to provide clarity to the market on all 35 settings as soon as practicable, in line with the provisions and processes set out in the Benchmarks Regulation and applicable governance procedures. The more time that markets have to prepare, the better.

Deepak, how does all that interact with the spread calculation contemplated in the ISDA documents?

There are a number of aspects to ISDA's fallbacks work:

- The IBOR Fallbacks Protocol for legacy positions entered into before January 25, 2021.
- The IBOR Fallbacks Supplement to the 2006 ISDA Definitions for transactions incorporating those definitions from January 25, 2021. While the supplement is in final form, it has not yet 'gone live'.
- Bloomberg's IBOR Fallback Rate Adjustments Rule Book that sets out how the spread is calculated and when it is fixed. While ISDA will no doubt coordinate closely with Bloomberg, it will be for Bloomberg to assess when the spread is fixed in accordance with the methodology set out in its rule book.

The first thing to say is that, as per ISDA's announcement on Monday, IBA's announcement of an intention to consult on the cessation of LIBOR is not sufficient to be an Index Cessation Event under the ISDA documents or a Spread Adjustment Fixing Date under the Bloomberg rule book. This means it has not caused the spread to fix. Edwin mentioned the IBA consultations for all LIBOR currencies and the prospect of an announcement for all currencies and tenors soon after the consultation closes. Edwin also noted that he does not envisage any news before then that the panel would become non-representative before it ceased.

If that is the case, and the outcome of the consultation were in line with the proposals, an announcement relating to all US dollar LIBOR tenors would trigger a *fixing* of the spread for all tenors. The fact that different US dollar LIBOR tenors would have different end dates would not impact when the spread is fixed.

I should stress that this is very much fact dependent. So, for example, if there were an earlier announcement or an announcement did not cover all tenors, the time at which the spread would be fixed may be different.

A separate question is when the fallback rate, which includes the spread, is *applied*.

Looking at US dollar LIBOR, I would break the period from any announcement down into three distinct periods:

- Firstly, the period between the announcement and the end of 2021. US dollar LIBOR in all its tenors will continue to be published and will be representative, so swap contracts using those tenors would continue to do so. Effectively, no change.
- Secondly, the period between the end of 2021 and the end of June 2023:
  - All tenors except one week and two months would continue to be published and be representative, and so swaps that use those tenors would continue to do so. No change for those contracts.
  - If the one-week and two-month tenors are last published at the end of 2021, contracts that use those tenors can obviously no longer use those tenors. However, those contracts would not immediately fall back to the fallback rate. Instead, because the other US dollar LIBOR tenors continue to be available and be representative, the ISDA documents contemplate the rate being determined using

  - linear interpolation. This is not something Bloomberg would do. Rather, it is for the calculation agent under the swap.
  - The one-week rate can be calculated by interpolating between the overnight and one-month rates, and the two-month rate can be calculated by interpolating between the one-month and three-month rates.
- The final time period is from the end of June 2023 onwards:
  - At that point, the overnight, one-month, three-month, six-month and 12-month rates would cease to be published and so swaps would fall back to the fallback rate – ie, the Bloomberg-published compounded SOFR plus the spread adjustment. The spread applied here will have been fixed in early 2021, at the time of the announcement relating to all US dollar LIBOR tenors.
  - Similarly, as the one-week and two-month tenors can no longer be calculated using linear interpolation (because the overnight, one-month and three-month tenors would no longer be available), swaps using those tenors would also, from the end of June 2023, fall back to the fallback rate.

For more detail, it's worth flagging that there is a wealth of information on the Benchmark Reform and Transition From LIBOR page on ISDA's website, including various videos, FAQs on the fallbacks documents and a factsheet summarizing Bloomberg's approach to the fallback rate and spread fixing.

So, to be clear, Deepak, if there were to be an announcement early next year, after the IBA consultation, as to the cessation of US dollar LIBOR, this would trigger the spread calculation?

Yes, an announcement early next year for all US dollar LIBOR tenors would fix the spread for all tenors. And in that instance, the spread would be applied – that is to say, contracts would fall back to the fallback rate after June 2023, even for the one-week and two-month tenors.

Edwin, do you think it will be possible to maintain a representative US dollar LIBOR until end-June 2023?

Yes. The FCA would not be welcoming and supporting this proposed extension unless we were confident that representativeness thresholds could be maintained in terms of the number of panel banks. As some of the coverage of Monday's announcements has noted, we think this proposal more or less eliminates the risk of a so-called zombie panel in any of the LIBOR currencies. We have always wanted to avoid the risk of a large proportion of panel banks exiting the panel before a more orderly wind down could be achieved. This would have left a small, fragile and unrepresentative panel, which I think no one wanted to see.

David, can you talk about the announcements from the Federal Reserve, Federal Deposit Insurance Corporation (FDIC) and Office of the Comptroller of the Currency (OCC)?

Importantly, the Federal Reserve Board, FDIC and OCC together released supervisory guidance that makes it clear that given consumer protection, litigation and reputation risks, entering into new contracts that use US dollar LIBOR as a reference rate after December 31, 2021 would create safety and soundness risks, and they stated that they will examine bank practices accordingly.

The agencies encouraged banks to cease entering into new contracts that use US dollar LIBOR as a reference rate as soon as practicable and in any event by December 31, 2021. New contracts entered into before December 31, 2021 should either utilize a reference rate other than LIBOR or have robust fallback language that includes a clearly defined alternative reference rate after LIBOR's discontinuation.

There are some carve-outs for derivatives transactions post-2021 related to market-making for legacy (pre-2022) instruments and hedging or reducing client or bank exposures, but the message overall is that people should not expect much new activity in US dollar LIBOR after 2021.

On the Federal Reserve's part, we think this represents a significant step forward in the LIBOR transition. The proposed path and supervisory statements laid out on Monday would enable a clear end date for US dollar LIBOR and would promote the safety and soundness of the financial system. The announcements together lay out a path forward in which banks should stop writing new US dollar LIBOR contracts by the end of 2021, while most legacy contracts will be able to mature before LIBOR stops.

Edwin, the FCA's November 30 statement also mentioned restrictions on new use of US dollar LIBOR after end-2021. Can you explain how that would work?

While we have not yet issued a formal consultation on this, and any final approach would be subject to that consultation, we highlighted the proposed new powers for the FCA to restrict new use of a benchmark known to be ceasing, and noted that we would look to coordinate with US and other authorities as we developed our policy with regard to US dollar LIBOR.

Any restrictions applied by the FCA would apply to regulated financial instruments entered into by FCA-supervised firms.

Tom, how do you see a 1.5-year extension for US dollars in terms of the transition?

First, I want to echo the importance of understanding these announcements, and would encourage all market participants to read through each announcement carefully: IBA, FCA, ISDA, the Fed statement and the supervisory guidance.

It's particularly important to understand what IBA has communicated in its announcement on the consultation timeline, and think through what it means in terms of the ISDA IBOR Fallbacks Protocol and the fixing of the spread adjustment.

Second, taking a step back, I look at these various announcements as a complete package with two key messages:

- First, the supervisory guidance has a clear message that reinforces the importance of market participants preparing for no new LIBOR at the end of 2021. This aligns well with the work the ARRC has done to set out best practice recommendations for readiness, including systems, vendors and recommended timelines around discontinuing new LIBOR activity across cash products – all in advance of end-2021.
- Second, this establishes a potential mechanism that can help support the roll-off of a substantial portion of LIBOR-linked legacy contracts. That helps us focus in on the remaining legacy exposures that will extend past the mid-2023 date, and especially the tough legacy contracts that after mid-2023 won't have an effective means of transitioning away from LIBOR at its end. The ARRC's proposed legislative solution for these contracts is an essential part of a smooth transition.

Finally, I just want to note that these are some of the most consequential announcements on LIBOR in many years. We now have a clear proposed path for the wind down of US dollar LIBOR, with supervisory guidance that affirms all of our planning for no new LIBOR use at the end of 2021, and proposed cessation dates for LIBOR that will let most legacy contracts roll off. We now have a very good sense as to what needs to be done by the end of 2021, and we should be moving with all speed to make it happen. The ARRC has lots of tools, templates and resources to help make that happen.

Edwin, does the proposed extension to some of the US dollar tenors mean it is more likely that the end date for sterling, yen or other LIBOR panels changes?

The proposed extension to US dollar does not change the proposed end date for other currencies. We do not see a need to continue the sterling panel beyond end-2021, and we do not think the US dollar extension means the same is appropriate for sterling.

Edwin, is the pre-cessation trigger event still relevant?

Yes, in a particular context. That's because a possibility, in sterling for example, is that it is clear the panel will end, but the FCA has advised IBA that it envisages consulting on continued publication on a changed methodology – or synthetic – basis.

In that case, the FCA could announce that the rate will not be published on a representative basis beyond end-2021. That is a pre-cessation announcement. But the economic impact on the market and the timing is the same – an unambiguous triggering of the spread calculation on exactly the same day.

Edwin, how would the FCA calculate the spread that might be included in a synthetic LIBOR if you required publication in that way?

On November 18, we set out our proposals on what sort of methodology change we would envisage – term risk-free rates, plus a fixed credit spread.

We proposed to calculate the spread in exactly the same way as ISDA does, and drew attention in that consultation paper to the many benefits of having exactly the same number as in the ISDA and other fallbacks – in terms of maintaining hedges, and aligning with the approach taken by those who are transitioning away from the benchmark through the ISDA protocol, or cash product fallbacks recommended by national working groups.

As we repeatedly emphasize, no one should rely on a synthetic LIBOR. That's why it is so important to sign the protocol. But the approach we have proposed would mean that you can also sign the protocol in the knowledge that if it did appear necessary or desirable, and feasible, for the FCA to require publication of LIBOR on a synthetic basis, you would not have been better off if you'd waited for that outcome. Signing the protocol takes away the risk of ending up with no reference rate, while our proposed approach to synthetic takes away the risk that signing the protocol leaves you in a worse expected position than under synthetic.

And Edwin, what are the next steps in the FCA timeline?

Our consultation on designation and methodology change powers closes on January 18. We would consider responses and announce our policy framework – probably on the same sort of timeline as IBA announces its decisions.

Subsequent decisions actually to use our proposed new powers, for example in respect of sterling LIBOR, would of course need to wait until future consultations have taken place and proposed powers are on the statute book. Where we had a clear intent to consult on using those powers, for example in sterling, we will continue to make that clear to the market. As we have noted, in respect of yen and even more so in dollar, we will monitor progress on transition further before making any proposals.

Next year, we will also consult further on how we might use our powers to restrict use where a rate has a known impending cessation date. Subject to IBA's consultation, this could of course be the case for US dollar LIBOR, with short-term continuation until an end-date of June 2023.

And, as you know, for a rate like sterling LIBOR, where publication after end-2021 could – again, subject to consultation – be on a non-representative synthetic basis, there would also be a prohibition on new use.

Meanwhile, we expect market participants to continue to actively transition away from LIBOR in accordance with the timelines set out by the relevant national working groups. This expectation also applies to the five US dollar LIBOR tenors that will cease to be published after June 30, 2023 – ie, this does not give market participants a reason to not adhere to the ISDA IBOR Fallbacks Protocol or otherwise defer transition in relation to US dollar LIBOR.