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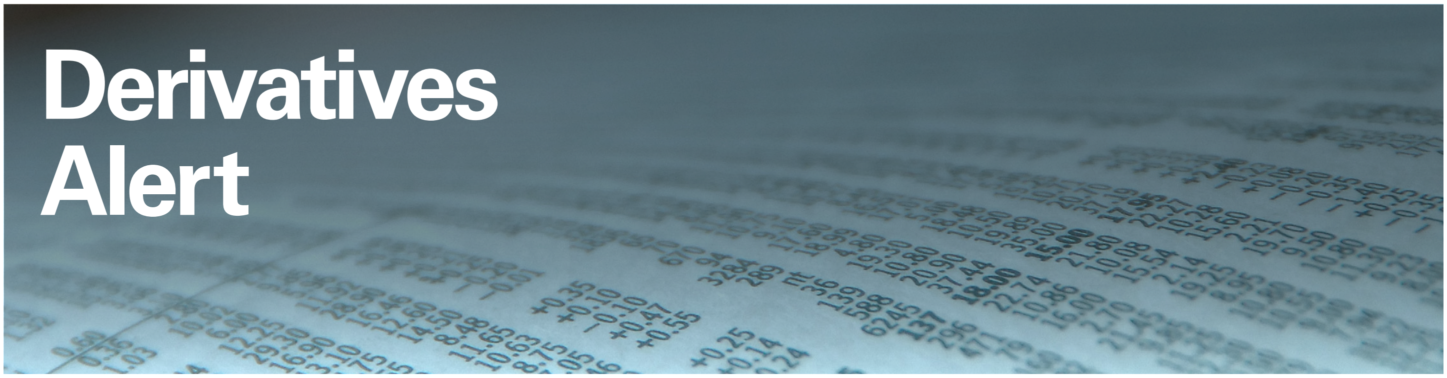

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IBOR Global Benchmark Transition Report Finds Gap Between Awareness and Action

On June 25, 2018, the International Swaps and Derivatives Association (ISDA) and other trade associations[1] published a report on the results of a survey of market participant preparedness for the anticipated global transition from interbank offered rates (IBORs) — in particular, the London Interbank Offered Rate (Libor) — to alternative risk-free rates (RFRs).[2] The "IBOR Global Benchmark Transition Report"[3] (Transition Report) gauges firms' readiness for the transition, identifies key elements needed for a successful transition and recommends steps that banks, other financial entities, financial and corporate end-users and infrastructure providers can take to prepare for the transition. The Transition Report finds that while market participants are aware of the transition and its potential impact, few firms have detailed action plans in place.

Background

In 2014, the Financial Stability Board (FSB)[4] observed that liquidity in transactions underlying certain IBORs had decreased to the point that the rates were no longer sustainable across all relevant tenors and recommended that financial markets transition to RFRs.[5]

[1] The Association for Financial Markets in Europe (AFME), the International Capital Market Association (ICMA), the Securities Industry and Financial Markets Association (SIFMA), and SIFMA's Asset Management Group (SIFMA AMG).

[2] For more on plans to transition from Libor to alternative reference rates, see our March 28, 2018, September 7, 2017, and August 15, 2017, client alerts. IBORs measure the interest rates at which banks borrow from one another. Libor, perhaps the most ubiquitous interest rate benchmark, is calculated daily in five currencies (U.S. dollar, pound sterling, euro, Swiss franc and Japanese yen) and in maturities ranging from overnight to one year. It is administered by ICE Benchmark Administration (IBA) and regulated by the U.K. Financial Conduct Authority. *See* "ICE Libor," ICE (last visited June 27, 2018); Andrew Bailey, "The Future of Libor," FCA (July 27, 2017) [hereinafter The Future of Libor]. Libor is referenced by approximately $350 trillion of outstanding contracts and is used as a benchmark rate for both derivatives and cash market products such as mortgages and corporate notes. *See* Luca Casiraghi, *et al.*, "Libor's Uncertain Succession Triggers $350 Trillion Headache," Bloomberg (July 27, 2017).

[3] *See* ISDA, *et al.*, "IBOR Global Benchmark Transition Report" (June 2018) [hereinafter Transition Report].

[4] The FSB is an international body that monitors and issues recommendations about the global financial system. *See* "About the FSB," FSB (last visited June 27, 2018).

[5] *See* FSB, "Reforming Major Interest Rate Benchmarks," at 1-2 (July 22, 2014).

Since then, groups in the United States,[6] United Kingdom,[7] European Union,[8] Switzerland[9] and Japan[10] have been working to identify RFRs to serve as alternatives to IBORs. To date, all of these jurisdictions except the EU have identified preferred RFRs. In June 2017, the U.S. working group, the Alternative Reference Rates Committee (ARRC), selected a broad repo rate (a rate tied to the cost of overnight borrowing collateralized by U.S. Treasury securities) as its preferred U.S. dollar Libor alternative.[11] In April 2018, the Federal Reserve Bank of New York began publishing the Secured Overnight Financing Rate (SOFR), which meets the criteria of the repo rate selected by the ARRC.[12]

The publication of SOFR set in motion the ARRC's "Paced Transition Plan" to transition markets from Libor to SOFR, beginning with developing market infrastructure for and building trading activity in derivatives referencing SOFR in 2018, and culminating with the creation of a term rate based on SOFR by the end of 2021.[13] The swaps and futures industry has already taken steps to implement the Paced Transition Plan. For example, trading has begun in one- and three-month SOFR futures contracts offered by the Chicago Mercantile Exchange (CME).[14] Likewise, CME and LCH, the clearing arm of the London Stock Exchange, expect to begin clearing over-the-counter SOFR swaps by the third quarter of 2018.[15]

The working groups — and the financial industry at large — face a daunting deadline. In July 2017, Andrew Bailey, the chief executive of the U.K. Financial Conduct Authority (FCA), Libor's regulator, announced that the FCA would no longer use its powers to persuade or compel banks to submit to Libor after 2021.[16] ISDA and other trade associations responded to this announcement less than a year later by publishing the "IBOR Global Benchmark Survey: 2018 Transition Roadmap" (Roadmap), which reported on the progress made by working groups around the world to facilitate a transition from IBORs to RFRs, and outlined some of the issues the transition poses.[17] Following the Roadmap's publication, the trade associations conducted a worldwide survey of 150 banks, market infrastructure providers, corporates and law firms to gauge market readiness for the transition.

Transition Report

Drawing on the survey, the Transition Report finds that while awareness of the impending benchmark transition and key transition issues is relatively strong, a significant gap lies between

[6] The U.S. IBOR-RFR transition working group is the Alternative Reference Rates Committee (ARRC), a group of financial institutions, trade associations and regulators convened in 2014 by the Federal Reserve Bank of New York. *See* "ARRC," ARRC (last visited June 27, 2018). While the ARRC was initially largely focused on how the transition would affect derivatives, it recently expanded its membership to enhance its focus on transition issues affecting cash market products. *See* "Membership for ARRC Broadened to Facilitate Libor Transition," ARRC (Mar. 7, 2018); "The ARRC Will Be Reconstituted Next Year," ARRC (Nov. 27, 2017).

[7] *See* "Transition to Sterling Risk-Free Rates From Libor," Bank of England (last visited June 27, 2018).

[8] *See* "Joint Press Release FSMA, ESMA, ECB and EC: New Working Group on a Risk-Free Reference Rate for the Euro Area," Eur. Cent. Bank (Sept. 21, 2017); *see also* "Working Group on Euro Risk-Free Rates," Eur. Cent. Bank (last visited June 27, 2018).

[9] *See* "Reform of Reference Interest Rates," Swiss Nat'l Bank (last visited June 27, 2018).

[10] *See* "Payments and Markets: Study Group of Market Participants," Bank of Japan (last visited June 27, 2018).

[11] *See* "The ARRC Selects a Broad Repo Rate as Its Preferred Alternative Reference Rate," ARRC (June 22, 2017).

[12] *See* our March 28, 2018, client alert; *see also* "Statement Introducing the Treasury Repo Reference Rates," Fed. Reserve Bank of N.Y. (Apr. 3, 2018). All other alternative reference rates designated by Libor currency jurisdiction working groups are now being published. *See* "SONIA Reform Implemented," Bank of England (Apr. 23, 2018); ISDA, *et al.*, "IBOR Global Benchmark Survey: 2018 Transition Roadmap," at 32 (Feb. 2018).

[13] *See* ARRC, "Second Report," at 17-24 (Mar. 2018).

[14] *See* "CME Group Announces First Trades of New SOFR Futures," CME (May 8, 2018).

[15] *See* Robert Mackenzie Smith, "LCH and CME to Start Clearing SOFR Swaps in Third Quarter," Risk (Apr. 11, 2018).

[16] *See* The Future of Libor. Moreover, under the EU Benchmarks Regulation, the majority of which began to apply on January 1, 2018, national authorities such as the FCA would not be able to compel banks to sustain a benchmark for more than 24 months. *See* "Regulation (EU) 2016/1011," Art. 23(6)(a)-(b) (June 8, 2016) [hereinafter BMR]. Libor submitter banks have agreed to continue supporting Libor through the end of 2021, *see* Katie Martin, "Banks Will Keep Supporting Libor until 2021-FCA," Fin. Times (Nov. 24, 2017), IBA has announced plans to reform Libor's calculation methodology to make the benchmark more reliant on actual transactions rather than submitters' judgment, *see* ICE, "ICE Libor Evolution" (Apr. 25, 2018) [hereinafter ICE Libor Evolution], and media reports indicate that at least some Libor submitter banks are open to contributing to the benchmark past 2021, *see* Robert Mackenzie Smith, "Some Banks Open to Committing to Libor Post-2021," Risk (June 11, 2018). Notably, however, the results of a pilot of IBA's proposed new Libor methodology revealed that most Libor fixings would still be heavily based on submitter banks' judgment. *See* ICE Libor Evolution at 19.

[17] *See generally* Roadmap. ISDA has launched an extensive array of benchmark reform working groups and initiatives. In addition to the programs discussed in the Roadmap and Transition Report, ISDA is also developing a supplement to ensure that its Definitions comply with the EU Benchmarks Regulation, which requires administrators and certain entities that use benchmarks to have procedures in place to address a cessation or material change in a benchmark. *See, e.g.*, Scott O'Malia, ISDA, "Now Is the Time to Think About Benchmarks" (Dec. 13, 2017); BMR Arts. 27-28.

knowledge and concrete steps to prepare for a transition from IBORs to RFRs.[18] For example, 87 percent of respondents were concerned about their exposure to IBORs, 76 percent had at least begun internal discussions regarding launching a transition program and 78 percent intend to begin trading products referencing RFRs within the next four years.[19] At the same time, only 12 percent had developed a preliminary project plan to address a transition, 11 percent had allocated resources and funds for a transition program and about 25 percent had yet to mobilize a transition program.[20]

Respondents cited a number of reasons for the inaction, including uncertainty as to how a transition would affect their IBOR exposures, uncertainty as to how trading in products referencing RFRs will develop, concerns about basis risk (*e.g.*, if cash products and derivatives that are used for hedging those products transition to RFRs at different times), uncertainty in how to address certain transition issues and lack of direction, guidance and communication from RFR working groups.[21]

The Transition Report discusses the key elements that survey respondents identified as paramount to transitioning to alternative rates successfully: long runways for transition, the need for widespread market adoption of and liquidity in products referencing RFRs and the need for a forward-looking term structure for RFRs.[22]

The Transition Report also pays particular attention to the following documentation issues and other challenges that already are arising because of the impending transition.

Fallback Language in Existing Derivatives, Loan and Bond Contracts

The 2006 ISDA Definitions provide fallbacks (rates that contracts can "fall back" to in the event of an IBOR cessation) for key IBORs to rates derived from bank polls, but they do not specify what steps counterparties should take if calculation agents are unable to procure quotes from banks.[23] As the Transition Report notes, banks may be unwilling to provide quotes, and even if they do, it may not be sustainable for a calculation agent to poll dealers for each calculation period for the lifetime of a transaction.[24] As a result, ISDA is working to develop fallbacks to alternative RFRs that could be used if a key IBOR is permanently discontinued as well as a set of triggers that would determine when a fallback would occur.[25] The fallbacks would apply to new transactions (*i.e.*, those entered into on or after the date of implementation of the fallbacks), but ISDA also plans to develop a protocol to implement fallbacks for existing transactions.[26]

However, amendments and protocols relevant to ISDA documentation typically do not apply to certain instruments such as cash market products. The Transition Report acknowledges challenges that the IBOR-RFR transition will pose for parties to corporate loans, bonds, floating rate notes, securitized products, consumer loans and residential mortgages. Existing fallback provisions for these instruments vary widely,[27] and a permanent cessation of a relevant IBOR could have numerous adverse effects, such as a significant increase in borrowing or lending costs for corporate loans, market disruptions for bond issuers and investors, and disruptions to cash flows or downgrades with respect to certain securitized products.[28] In addition, changes to contract terms for these instruments will often require the consent of most or all lenders, bondholders or noteholders.[29]

[18] *See* Transition Report at 8.

[19] *See id.* at 12 (Ex. 5.1.1), 13 (Ex. 5.1.2) & 18 (Ex. 5.3.1).

[20] *See id.* at 18 (Ex. 5.3.1).

[21] *See id.* at 8, 19-22.

[22] *See id.* at 8, 20, 26-34.

[23] *See id.* at 15.

[24] *See id.*

[25] *See id.* ISDA additionally appears to be taking steps to develop fallbacks that could apply to the RFRs themselves. *See, e.g.*, "Supplement Number 57 to the 2006 ISDA Definitions," ISDA (May 16, 2018) (outlining a series of fallbacks for the "USD-SOFR-Compound" rate).

[26] *See* Transition Report at 15. A protocol is a procedure that ISDA uses to allow counterparties to make standardized changes to contracts.

[27] For example, many loans fall back to rates based on quotes from reference banks, followed by an alternative rate such as the prime rate or Effective Federal Funds Rate plus a spread, or the rate given when individual banks notify the calculation agent of their cost of funds. Similarly, bonds often fall back to a rate based on a bank poll, followed by the last available IBOR rate (which would effectively turn a floating rate into a fixed rate). And securitized products frequently fall back to rates based on bank polls followed by a designated successor rate or the last available IBOR rate, depending on product type. *See id.* at 15-16.

[28] *See id.* at 16. For example, the ARRC noted that some investors, such as money market funds, would be unable or unwilling to hold fixed rate notes, and a fallback to the last IBOR fixing could result in a forced sale of notes. *Id.*

[29] *See id.*

Basis Risk

Survey respondents expressed concerns related to basis risk stemming from the possibility that the fallback for a cash market product could trigger at a different time than the fallback for a derivative that is used to hedge the cash product.[30] The Transition Report additionally notes ongoing debate over whether derivatives should reference term RFRs as opposed to the RFRs themselves, citing concerns over whether RFR term rates would be robust enough to support the volume of transactions that may be pegged to them.[31] With respect to cross-currency swaps, the Transition Report notes that respondents were concerned that timing differences in the transition for RFRs for each currency could lead to market disruption, particularly as RFRs in different jurisdictions are not necessarily determined based on a single methodology.[32] Survey respondents additionally cited concerns regarding valuation of cross-currency swaps where some alternative RFRs are secured while others are not.[33]

Amending Contract Language

The Transition Report notes potential challenges in amending contractual language across a variety of products to incorporate new fallback rates. Generally, swaps and futures contracts, using ISDA documentation, can be amended through the use of protocols.[34] However, survey respondents indicated that implementing a protocol for contracts referencing IBORs could be difficult due to the volume of contracts that would need to be amended, and protocols may not be appropriate where contract parties must agree to commercial terms bilaterally and on an arm's-length basis.[35] Parties to cash market products would also face challenges. For example, the Transition Report explains that commercial loan contracts are typically not standardized, may require bilateral negotiation between borrowers and lenders, and may require unanimous consent to make changes to reference rates.[36] Similarly, consumer loans and mortgages may require bilateral negotiation between lenders and borrowers to amend contract terms. Additionally, while the owner of the loan often has the right to choose a replacement index, the contract may not provide for the selection of an adjustment to the replacement index, such as the application of a credit spread.[37] With respect to bonds and securitized products, consent of a quorum or all bondholders or noteholders may be required to make changes.[38]

Other Issues

Other issues noted in the Transition Report include concerns that RFRs will lack a credit premium and term rate.[39] For instance, whereas Libor accounts for bank credit risk and is available in multiple tenors, the alternative RFRs are risk-free and overnight only.[40] ISDA is launching a consultation on the methodology that should be used to apply a credit spread to SOFR, expected to be released in the coming weeks.[41] The Transition Report also highlights institutional concern about the potential for litigation risk that the transition poses, particularly with counterparties that are fiduciaries, retail investors or borrowers. For instance, where a bank negotiates to amend an existing contract to reference an RFR, and the IBOR being replaced continues to be published, the bank may run the risk of a claim from its counterparty based on the difference in value had the contract continued to use the IBOR under the contract's original terms.[42] The Transition Report also cites regulatory concerns, such as whether existing positions that are modified to reference alternative RFRs or include fallbacks would be brought into the scope of clearing and margin requirements.[43]

[30] *See id.* at 21. The Transition Report notes that while market participants may have the opportunity to negotiate amendments to derivatives that hedge cash products at the time that they amend the cash products to ensure that contract terms are aligned, it will be critical for firms to understand which derivatives hedge which cash products. *See id.*

[31] *See id.*

[32] *See id.*

[33] *See id.*

[34] *See id.* at 25.

[35] *See id.*

[36] *See id.*

[37] *See id.*

[38] *See id.* Additionally, the Transition Report notes that with respect to securitized products, noteholders may be anonymized and therefore difficult to identify. *Id.*

[39] *See id.* at 24, 33.

[40] *See id.* at 24.

[41] *See* Scott O'Malia, "Benchmark Regulation and Transition, Hong Kong: Opening Comments and Overview of Benchmark Reform Initiatives," ISDA (May 15, 2018); Lucas Becker, "Swaps Users to Get Three Choices for Synthetic Libor," Risk (May 14, 2018). SOFR generally trades lower than Libor, and a switch from Libor to SOFR in a contract (for instance, upon triggering of a fallback) could result in a transfer of value from one party to another. *See* Barry Mills, "From Libor to SOFR," ABA Banking J. (Feb. 21, 2018). Thus, many see a credit spread as a necessary element of a fallback to an RFR.

[42] *See* Transition Report at 24.

[43] *See id.* at 30. For more on regulatory issues, see our August 15, 2017, client alert.

Call to Action

Against the looming 2021 deadline, the Transition Report identifies an implementation checklist to guide the financial industry and corporates in preparing for the transition.[44] The checklist recommends:

- creating a formal IBOR transition program;
- assessing exposure to IBORs and the impact of a transition;
- designing robust fallbacks;
- participating in the design and trading of products benchmarked to RFRs;
- outlining an external communication strategy; and
- creating a transition roadmap.

ISDA Chief Executive Scott O'Malia noted that, "The transition from the IBORs to alternative RFRs will have an impact across financial markets — from derivatives to bonds to mortgages. It's vital that firms commit resources and begin their transition planning initiatives. ... Given the scale of the task, th[e] implementation checklist should be adopted now."[45] By calling for market participants to undertake plans now to address a transition to RFRs, the Transition Report underscores that regulators expect market participants to take responsibility for their own transition plans.[46]

Market participants should note that the ARRC recently announced a roundtable, scheduled for July 19, 2018, where the body will report on its progress since its membership was reconstituted in March 2018 to focus more sharply on certain transition issues (including how the transition will affect cash market products).[47] The ARRC intends the roundtable to be a starting point for its "public consultation and education process regarding contract robustness in instruments referencing Libor." [48]

[44] *See* Transition Report at 35-36 (Table 6.1).

[45] Press Release, "ISDA, AFME, ICMA, SIFMA and SIFMA AMG Publish Global Benchmark Report," ISDA (June 25, 2018).

[46] *See* The Future of Libor. In announcing plans to transition from Libor to alternative reference rates, Bailey noted, "Market participants must take responsibility for their individual transition plans, but we and other authorities will be ready to assist and support efforts to co-ordinate that work." *Id.*

[47] See *supra* n.6.

[48] *See* "Meetings," ARRC (last visited June 27, 2018).

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